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THE SECURITIES LAW ENFORCEMENT REMEDIES ACT OF 1989

HEARINGS

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON

BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

S. 647

TO AMEND THE FEDERAL SECURITIES LAWS TO REVISE THE ENFORCEMENT REMEDIES FOR CIVIL VIOLATIONS OF THOSE LAWS

FEBRUARY 1 AND 8, 1990

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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THE SECURITIES LAW ENFORCEMENT REMEDIES ACT OF 1989

THURSDAY, FEBRUARY 1, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, DC.

The subcommittee met at 9:45 a.m., in room SD-538, Dirksen Senate Office Building, Senator Christopher J. Dodd (chairman of the subcommittee) presiding.

Present: Senators Dodd, Riegle, Wirth, Heinz, Pressler, and D'Amato.

OPENING STATEMENT OF SENATOR DODD

Senator DODD. The Subcommittee on Securities will come to order.

I want to welcome everyone this morning to our first hearing on S. 647, the Securities Law Enforcement Remedies Act. This is legislation that Senator Heinz and I introduced last March at the request of the Securities and Exchange Commission.

Since this is the first hearing of the Securities Subcommittee this session, it might be useful to note just where we are in the legislative process on a number of securities bills before this subcommittee and the full committee, and before the Senate.

A package of four measures that were passed by the Senate last year are now pending in the House: the SEC's authorization bill, the International Securities Enforcement Cooperation Act, amendments to the Shareholder Communications Improvement Act, and amendments to the Trust and Indenture Reform Act. I understand those measures may be taken up by the House in the next few weeks, and I hope we can resolve our differences quickly.

As most of you know, the committee reported S. 648, the Market Reform Act, last November. Mr. Chairman, we hope that we will have it ready for the floor action early this spring. I have been told by the majority leader that it should be on the schedule.

I would note that after the committee acted on the measure, Secretary Brady as well as Chairman Breeden made a number of reported comments about the need to address the margin and jurisdiction issues. Senator Heinz and I wrote Secretary Brady and Chairman Breeden earlier this year, asking for specific recommendations in these areas.

We really have to know where the administration is on these questions, which have been so politically divisive in the past. And I hope that we can move on and pass the Market Reform bill this spring.

In addition, last November, the subcommittee held hearings on a number of takeover bills introduced by our colleagues. Senator Heinz and I have asked Secretary Brady and Chairman Breeden for their views on those bills by March 1, if at all possible.

We also have a long-standing request of the SEC for its evaluation of the leveraged buyout phenomenon. Based on my conversation with Chairman Breeden yesterday, that report, which we expected to receive last May, will be ready in the very near future.

I have always believed that there was a great deal more heat than light on those issues, and it is terribly important to have all the facts before moving ahead.

Let me now turn to S. 647, which is the business of the subcommittee this morning. The legislation would strengthen the SEC's enforcement powers by authorizing new civil fines for a range of securities violations. The bill would also provide some specific authority to bar those who violate the law from serving as officers and directors of public companies. And if we determine to add a new provision developed by Chairman Breeden, the bill would also give the SEC "cease and desist" authority for the first time.

We are considering this bill at a time when the demand for tough, effective enforcement of our Nation's securities laws has never been greater. In recent years, we have seen financial frauds of historic proportions. Insider trading, market manipulation, so-called "penny stock fraud," and other activities, have sent the message to Main Street, "Investor Beware."

Fraudulent accounting practices and other illegal activity in the thrift industry has cost shareholders as well as taxpayers billions of dollars. It goes without saying that our capitalist system is founded on free markets; but they must be fair markets as well, markets in which investors have confidence. That is why the SEC was created. That is why we are here today considering ways to make it even more effective.

At the same time, even though I sponsored the bill, I think we must resist the temptation just to pass the bill simply because tough enforcement is the theme of the day. Pass the bill, authorize more penalties, declare victory, and go home.

Let me emphasize, that is not the purpose of this hearing today. The SEC already has a tremendous arsenal of enforcement powers, ranging from administrative sanctions to the ability to refer matters for criminal prosecution. We will ask whether the agency needs still more enforcement powers. We also will ask whether provisions of the bill could have an unintended reach that could undermine public support for the enforcement program as a whole.

Let me add that no amount of new powers will reduce fraud in the securities markets, unless would-be violators believe their illegal activity will be detected. What I am suggesting is that a fully funded SEC with a qualified, dedicated staff, is infinitely more important in my view than new enforcement tools. I think my colleagues would agree with that, and I believe Chairman Breeden would as well.

Finally, I would venture that the most important recent step Chairman Breeden has taken to ensure the effectiveness of the

SEC's enforcement program is the appointment of Bill McLucas as Director of the Division. I want to commend you, Mr. Chairman, on your choice of a dedicated career lawyer, who commands the respect of his colleagues.

That move, as well as the strong support you have shown for the Commission's enforcement program from the very beginning, provides great motivation for the staff. And as I said earlier, that is where the strength of your enforcement program ultimately rests.

I want to thank the Chairman for being with us this morning, and my colleagues as well, and I look forward to a productive hearing.

[Copy of proposed bill follows:]

II

101st CONGRESS
1st Session

S. 647

To amend the Federal securities laws in order to provide additional enforcement remedies for violations of those laws.

IN THE SENATE OF THE UNITED STATES

March 17 (legislative day, January 3), 1989

Mr. Dodd (for himself and Mr. Heinz) (by request) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To amend the Federal securities laws in order to provide additional enforcement remedies for violations of those laws.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; TABLE OF CONTENTS; EFFECTIVE DATE.

(a) Short Title.—This Act may be cited as the "Securities Law Enforcement Remedies Act of 1989".

(b) Table of Contents.—

TITLE I—AMENDMENTS TO THE SECURITIES ACT OF 1933

Sec. 101. Authority of a court to prohibit persons from serving as officers and directors.
Sec. 102. Monetary penalties in civil proceedings.

TITLE II—AMENDMENTS TO THE SECURITIES EXCHANGE ACT OF 1934

Sec. 201. Amendments to section 15(c)(4).
Sec. 202. Enforcement of title.
Sec. 203. Monetary penalties in administrative proceedings.
Sec. 204. Conforming amendment to section 15B.

TITLE III—AMENDMENTS TO THE INVESTMENT COMPANY ACT OF 1940

Sec. 301. Monetary penalties in administrative proceedings.
Sec. 302. Enforcement of title.

TITLE IV—AMENDMENTS TO THE INVESTMENT ADVISERS ACT OF 1940

Sec. 401. Monetary penalties in administrative proceedings.
Sec. 402. Enforcement of title.
Sec. 403. Conforming amendment to section 214.

(c) EFFECTIVE DATE.—The amendments made by this Act shall not apply to any conduct occurring before the date of the enactment of this Act.

TITLE I—AMENDMENTS TO THE SECURITIES ACT OF 1933

SEC. 101. AUTHORITY OF A COURT TO PROHIBIT PERSONS FROM SERVING AS OFFICERS AND DIRECTORS.

Section 20(b) of the Securities Act of 1933 (15 U.S.C. 77t(b)) is amended by inserting after the first sentence thereof the following: "In any proceeding under this subsection, the court may prohibit, conditionally or unconditionally, either permanently or for such period of time as it shall determine, any person found to have violated any provision of this title or any rule or regulation thereunder from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l) or that is required to file reports pursuant to subsection (d) of section 15 of such Act (15 U.S.C. 78o).”

SEC. 102. MONETARY PENALTIES IN CIVIL PROCEEDINGS.

Section 20 of the Securities Act of 1933 (15 U.S.C. 77t) is amended—

(1) by redesignating subsection (c) as subsection (d); and

(2) by inserting after subsection (b) the following:

“(c)(1) Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder, the Commission may bring an action seeking to impose, and the court shall have jurisdiction to impose, based upon a finding of a violation, a civil penalty against such person. The amount of the penalty shall be determined by the court in light of the facts and circumstances. For each violation, the amount of the penalty shall not exceed the greater of (1) $100,000 for a natural person or $500,000 for any other person, or (2) the gross amount of pecuniary gain to such defendant as a result of the violation. The penalty shall be payable into the Treasury of the United States.

“(2) If a person upon whom a penalty is assessed under this subsection fails to pay such penalty within the time prescribed in the court’s order, the Commission shall refer the matter to the Attorney General who shall recover such penalty by action in the appropriate United States district court.

"(3) The actions authorized by this subsection may be brought in addition to any other actions that the Commission or the Attorney General is entitled to bring. For purposes of section 22 of this title, actions under this subsection shall be actions to enforce a liability or a duty created by this title.".

TITLE II—AMENDMENTS TO THE SECURITIES EXCHANGE ACT OF 1934

SEC. 201. AMENDMENTS TO SECTION 15(C)(4).

Section 15(c)(4) of the Securities Act of 1934 (15 U.S.C. 78o(c)(4)) is amended—

(1) by striking ", or" the first time it appears; and

(2) by inserting after "15" the following: ", or subsection (a) of section 16"; and

(3) by adding at the end thereof the following: "In such an order, the Commission may also prohibit, conditionally or unconditionally, either permanently or for such period of time as it shall determine, any person found to have failed to comply or to have been a cause of the failure to comply from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 12 of this title or that is required to file reports pursuant to subsection (d) of sec-

tion 15 of this title, if the Commission finds that such prohibition is in the public interest.".

SEC. 202. ENFORCEMENT OF TITLE.

Section 21(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78u(d)) is amended to read as follows:

"(d)(1) Whenever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this title, the rules or regulations thereunder, the rules of a national securities exchange or registered securities association of which such person is a member or a person associated with such member, the rules of a registered clearing agency in which such person is a participant, or the rules of the Municipal Securities Rulemaking Board, the Commission may in its discretion bring an action in the proper district court of the United States, the United States District Court for the District of Columbia, or the United Sates courts of any territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. In any proceeding under this paragraph, the court may prohibit, conditionally or unconditionally, either permanently or for such period of time as it shall determine, any person found to have violated any provision of this title or the rules and regulations thereunder from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 12 of this title or that is required to file reports pursuant to subsection (d) of section 15 of this title. The Commission may transmit such evidence of acts or practices as may constitute a violation of any provision of this title or the rules or regulations thereunder to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this title.

"(2) Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder, other than by committing a violation subject to a penalty pursuant to section 21A, the Commission may bring an action seeking to impose, and the court shall have jurisdiction to impose, based upon a finding of a violation, a civil penalty against such person. The amount of the penalty shall be determined by the court in light of the facts and circumstances. For each violation, the amount of the penalty shall not exceed the greater of (A) $100,000 for a natural person or $500,000 for any other person, or (B) the gross amount of pecuniary gain to such defendant as a result of the violation. The penalty shall be payable into the Treasury of the United States. If a person upon whom such a penalty is assessed shall fail to pay such penalty within the time prescribed in the court's order, the Commission shall refer the matter to the Attorney General who shall recover such penalty by action in the appropriate United States district court. The action authorized by this paragraph may be brought in addition to any other action that the Commission or the Attorney General is entitled to bring. For purposes of section 27 of this title, actions under this paragraph shall be actions to enforce a liability or a duty created by this title.".

SEC. 203. MONETARY PENALTIES IN ADMINISTRATIVE PROCEEDINGS.

The Securities Exchange Act of 1934 is amended by inserting after section 21A (15 U.S.C. 78u–1) the following:

"MONETARY PENALTIES IN ADMINISTRATIVE PROCEEDINGS

"SEC. 21B. (a) In any proceeding instituted pursuant to section 15(c)(4) of this title against any person, the Commission may assess a civil penalty if it finds, on the record after notice and opportunity for hearing, that such person—

"(1) failed to comply with any provision of sections 12, 13, 14, subsection (d) of section 15, or subsection (a) of section 16 of this title, or any rule or regulation thereunder, in any material respect, or

"(2) was a cause of any other person's failure to so comply due to an act or omission the person knew or should have known would contribute to the failure to comply,

and that such penalty is in the public interest. The maximum amount of the penalty for each failure to comply or for each such failure to comply for which a person was a cause, shall be $100,000 for a natural person or $500,000 for any other person.

"(b) In any proceeding instituted pursuant to section 15(b)(4), 15(b)(6), 15B, 15C, or 17A of this title against any person, the Commission or the appropriate regulatory agency may assess a civil penalty if it finds, on the record after notice and opportunity for hearing, that such person—

"(1) has willfully violated any provision of the Securities Act of 1933 (15 U.S.C. 77a et seq.), the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 et seq.), or this title, or the rules or regulations thereunder, or the rules of the Municipal Securities Rulemaking Board;

"(2) has willfully aided, abetted, counseled, commanded, induced, or procured such a violation by any other person;

"(3) has willfully made or caused to be made in any application for registration or report required to be filed with the Commission or with any other appropriate regulatory agency under this title, or in any proceeding before the Commission with respect to registration, any statement which was at the time in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which is required to be stated therein; or

"(4) has failed reasonably to supervise within the meaning of section 15(b)(4)(E) of this title, with a view to preventing violations of the provisions of such statutes, rules and regulations, another person who commits such a violation, if such other person is subject to his supervision;

and that such penalty is in the public interest. The maximum amount of penalty for each such act or omission shall be $100,000 for a natural person or $500,000 for any other person.

"(c) In consideration under this section whether a penalty is in the public interest, the Commission or the appropriate regulatory agency may consider—

"(1) whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;

"(2) the harm to other persons resulting either directly or indirectly from such act or omission;

"(3) the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior;

"(4) whether such person previously has been found by the Commission, other appropriate regulatory agency, or self-regulatory organization to have violated the Federal securities laws, State securities laws, or the rules of a self-regulatory organization, or has been enjoined by a court of competent jurisdiction from violations of such laws or rules;

"(5) the need to deter such person and other persons from committing such acts or omissions; and

"(6) such other matters as justice may require.

"(d) In any proceeding in which the Commission or the appropriate regulatory agency may assess a penalty under this section, a respondent may present evidence of the respondent's ability to pay such penalty. The Commission or the appropriate regulatory agency may, in its discretion, consider such evidence in determining whether such penalty is in the public interest. Such evidence may relate to the extent of such person's ability to continue in business, and the collectability of a penalty, taking into account any other claims of the United States or third parties upon such person's assets and the amount of such person's assets.".

SEC. 204. CONFORMING AMENDMENTS TO SECTION 15B.

Section 15B(c)(6)(A) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-4(c)(6)(A)) is amended—

(1) by striking "and" after "identity of such municipal securities dealer or person associated with such municipal securities dealer" and inserting a comma;

(2) by inserting a comma after "proposed action"; and

(3) by inserting before "(ii)" the following: "whether the Commission is seeking a monetary penalty against such municipal securities dealer or such associated person pursuant to section 21B of this title; and".

TITLE III—AMENDMENTS TO THE INVESTMENT COMPANY ACT OF 1940

SEC. 301. MONETARY PENALTIES IN ADMINISTRATIVE PROCEEDINGS.

Section 9 of the Investment Company Act of 1940 (15 U.S.C. 80a-9) is amended—

(1) by redesignating subsection (d) as subsection (e);

(2) by inserting after subsection (c) the following:

"(d)(1) In any proceeding instituted pursuant to subsection (b) against any person, the Commission may assess a civil penalty if it finds, on the record after notice and opportunity for hearing, that such person—

"(A) has willfully violated any provision of the Securities Act of 1933 (15 U.S.C. 77a et seq.), the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 et seq.), or this title, or the rules or regulations thereunder;

"(B) has willfully aided, abetted, counseled, commanded, induced, or procured such a violation by any other person; or

"(C) has willfully made or caused to be made in any registration statement, application, or report required to be filled with the Commission under this title, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such registration statement, application, or report any material fact which was required to be stated therein;

and that such penalty is in the public interest. The maximum amount of the penalty for each such act or omission shall be $100,000 for a natural person or $500,000 for any other person.

"(2) In considering under this section whether a penalty is in the public interest, the Commission may consider—

"(A) whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, of deliberate or reckless disregard of a regulatory requirement;

"(B) the harm to other persons resulting either directly or indirectly from such act or omission;

"(C) the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior;

"(D) whether such a person previously has been found by the Commission, other appropriate regulatory agency, of self-regulatory organization to have violated the Federal securities laws, State securities laws, or the rules of a self-regulatory organization, or has been enjoined by a court of competent jurisdiction from violations of such laws or rules;

"(E) the need to deter such person and other persons from committing such acts or omissions; and

"(F) such other matters as justice may require.

"(3) In any other proceeding in which the Commission may assess a penalty under this section, a respondent may present evidence of the respondent's ability to pay such penalty. The Commission may, in its discretion, consider such evidence in determining whether such penalty is in the public interest. Such evidence may relate to the extent of such person's ability to continue in business, and the collectability of a penalty, taking into account any other claims of the United States or third parties upon such person's assets and the amount of such person's assets."; and

(3) in redesignated subsection (e), by striking the following: "subsections (a) through (c) of".

SEC. 302. ENFORCEMENT OF TITLE.

Section 42 of the Investment Company Act of 1940 (15 U.S.C. 80a–41) is amended by—

(1) inserting after the first sentence of subsection (d) the following: "In any proceeding under this subsection the court may prohibit, conditionally or unconditionally, either permanently or for such period of time as it shall determine, any person found to have violated any provision of this title or any rule, regulation, or order hereunder from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l) or that is required to file reports pursuant to subsection (d) of section 15 of such Act (15 U.S.C. 78o(d))."; and

(2) adding at the end the following:

"(e) Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder, the Commission may bring an action seeking to impose, and the court shall have jurisdiction to impose, based upon a finding of a violation, a civil penalty against such person. The amount of the penalty shall be determined by the court in light of the facts and circumstances. For each violation, the amount of the penalty shall not exceed the greater of (1) $100,000 for a natural person or $500,000 for any other person, or (2) the gross amount of pecuniary gain to such defendant as a result of the violation. The penalty shall be payable into the Treasury of the United States. If a person upon whom such a penalty is assessed shall fail to pay such penalty within the time prescribed in the court's order, the Commission shall refer the matter to the Attorney General who shall recover such penalty by action in the appropriate United States district court. The actions authorized by this subsection may be brought in addition to any other actions that the Commission or the Attorney General is entitled to bring. For purposes of section 44 of this title, actions under this subsection shall be actions to enforce a liability or a duty created by this title.".

TITLE IV—AMENDMENTS TO THE INVESTMENT ADVISERS ACT OF 1940

SEC. 401. MONETARY PENALTIES IN ADMINISTRATIVE PROCEEDINGS.

Section 203 of the Investment Advisers Act of 1940 (15 U.S.C. 80b–3) is amended by adding at the end the following:

"(i)(1) In any proceeding instituted pursuant to subsection (e) or (f) against any person, the Commission may assess a civil penalty if it finds, upon the record after notice and opportunity for hearing, that such person—

"(A) has willfully violated any provision of the Securities Act of 1933 (15 U.S.C. 77a et seq.), the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), the Investment Company Act of 1940 (15 U.S.C. 80a–1 et seq.), or this title, or the rules and regulations thereunder;

"(B) has willfully aided, abetted, counseled, commanded, induced, or procured such a violation by any other person;

"(C) has willfully made or caused to be made in any application for registration or report required to be filed with the Commission under this title, or in any proceeding before the Commission with respect to registration, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such registration statement, application, or report any material fact which was required to be stated therein; or

"(D) has failed reasonably to supervise, within the meaning of section 203(e)(5) of this title, with a view to preventing violations of the provisions of this title and such rules and regulations, another person who commits such a violation, if such other person is subject to his supervision;

and that such penalty is in the public interest. The maximum amount of the penalty for each such act or omission shall be $100,000 for a natural person or $500,000 for any other person.

"(2) In considering under this section whether a penalty is in the public interest, the Commission may consider—

"(A) whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;

"(B) the harm to other persons resulting either directly or indirectly from such act or omission;

"(C) the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior;

"(D) whether such a person previously had been found by the Commission, other appropriate regulatory agency, or self-regulatory organization to have violated the Federal securities laws, State securities laws, or the rules of a self-regulatory organization, or has been enjoined by a court of competent jurisdiction from violations of such laws or rules;

"(E) the need to deter such person and other persons from committing such acts or omissions; and

"(F) such other matters as justice may require.

"(3) In any proceeding in which the Commission may assess a penalty under this section, a respondent may present evidence of the respondent's ability to pay such penalty. The Commission may, in its discretion, consider such evidence in determining whether such penalty is in the public interest. Such evidence may relate to the extent of such person's ability to continue in business, and the collectability of a penalty, taking into account any other claims of the United States or third parties upon such person's assets and the amount of such person's assets.".

SEC. 402. ENFORCEMENT OF TITLE.

Section 209 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-9) is amended—

(1) by inserting after the first sentence of subsection (d) the following: "In any proceeding under this paragraph, the court may prohibit, conditionally or unconditionally, either permanently or for such period of time as it shall determine, any person found to have violated any provision of this title, or of any rule, regulation, or order hereunder or has aided, abetted, counseled, commanded, induced, or procured such a violation, from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l) or that is required to file reports pursuant to subsection (d) of section 15 of such Act (15 U.S.C. 78o)."; and

(2) by adding at the end the following:

"(e) Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder, the Commission may bring an action seeking to impose, and the court shall have jurisdiction to impose, based upon a finding of a violation, a civil penalty against such person. The amount of the penalty shall be determined by the court in light of the facts and circumstances. For each violation, the amount of the penalty shall not exceed the greater of (1) $100,000 for a natural person or $500,000 for any other person, or (2) the gross amount of pecuniary gain to such defendant as a result of the violation. The penalty shall be payable into the Treasury of the United States. If a person upon whom such a penalty is assessed shall fail to pay such penalty within the time prescribed in the court's order, the Commission shall refer the matter to the Attorney General who shall recover such penalty by action in the appropriate United States district court. The actions authorized by this subsection may be brought in addition to any other actions that the Commission or the Attorney General is entitled to bring. For purposes of section 214 of this title, actions under this subsection shall be actions to enforce a liability or a duty created by this title.".

SEC. 403. CONFORMING AMENDMENT TO SECTION 214.

Section 214 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-14) is amended—

(1) by inserting after "all suits in equity", the following: "and actions at law brought to enforce any liability or duty created by, or"; and

(2) by inserting after "Any suit or action", the following: "to enforce any liability or duty created by, or".

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Senator DODD. Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, I want to join you in welcoming Richard Breeden and Bill McLucas to this morning's hearing. This is their first appearance before our subcommittee in their new capacities of Chairman and Enforcement Director.

I observed, when you and I, Mr. Chairman, first introduced S. 647 last year, I spoke of the need for a tough Federal marshal to clean up the securities markets. Mr. Chairman, I agree with you that the two gentlemen before us fit the bill.

Richard Breeden and Bill McLucas have the necessary ability, experience, and toughness, and they certainly know the terrain. I do not foresee any ambushes catching them by surprise. But they are going to have to draw upon those talents, because the challenges that lie ahead are enormous ones.

The markets have changed dramatically in recent years, and they are going to continue to evolve very rapidly indeed. Internationalization, institutionalization, technological developments, all of these are principal factors which are going to continue to accelerate, and of course which shape the new financial landscape.

New products are created, new trading strategies are devised which require the securities laws and the regulators to be able to adapt to a changing environment. Without the ability to adapt, we may find it difficult to survive the forces of competition in the global marketplace.

These changes bring new opportunities for both those who use the securities markets to raise capital and for those who profit from illegal activities. Today, we are going to look at ways to strengthen the Federal securities laws, to ensure that the Securities and Exchange Commission has the most effective tools available to combat securities fraud.

I do not think that this police force, the SEC or any police force, can effectively police our markets with the regulatory equivalent of 19th century six-shooters, when today's white collar criminals are armed with the equivalent of assault rifles.

S. 647 would provide the SEC with new, potent enforcement tools. First, it would permit the SEC to impose civil fines for a wide a range of securities law violations. Second, it would provide for securities laws violators to be barred from serving as officers or directors of publicly held corporations. That is tough. In addition, the SEC is today proposing to add authority to issue cease and desist orders.

A cautionary note: Obviously, before we issue the SEC new enforcement weapons—and in general, we agree that they are needed—we have got to give very careful consideration to how they will fit into the Commission's existing arsenal of remedies.

Some commentators have suggested that the Commission has ample authority to protect investors. And while I do not necessarily agree with it, some commentators express the view that S. 647 would make the SEC's enforcement program punitive rather than remedial. Others have expressed concerns about the SEC's ability to impose sanctions without sufficient guidelines or limitations.

Mr. Chairman, I commend you on holding these hearings. I look forward to working with you, Senator Dodd. I think S. 647 raises a number of important legal and policy issues which we do need to consider. I think this hearing and the panelists are going to be very, very useful. I look forward to coming to a very rapid conclusion on these issues, however complex and important that they may be.

Thank you very much, Mr. Chairman.

Senator DODD. Thank you, Senator Heinz.

Chairman Riegle.

OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. At the outset, Chairman Dodd, I want to commend you and Senator Heinz, and the entire subcommittee, for the excellent work last year. I think you have already compiled a very impressive record of achievement.

The full Senate has passed the Securities Amendment of 1989, which includes the SEC authorization of the International Securities Enforcement Cooperation Act, the Shareholders Communication Improvement Act, and the Trust Indenture Reform Act. I think the House plans to move on these legislative items soon, also.

I would add, as a result of your work, Mr. Chairman, the full committee has already acted on the Market Reform Act of 1989. I would hope that, if the signals that we are getting are right, we will be able to take this legislation to the Senate floor shortly.

Given the recent volatility in the market, I think it is important that the full Senate consider this bill as soon as possible. However, in order to expedite the process, we are going to need the active support and involvement of the Commission, of the Chairman, and of the Bush administration.

This year, we have made passage of the Securities Law Enforcement Remedies Act a priority of the committee. I want you to know that the subcommittee will have my full support in scheduling hearings and mark-up on this legislation, as soon as you are ready to go. I would hope that we will be able to act on S. 647 during the early part of the year.

Let me just say, with respect to today's hearings, I think we have a particularly impressive group of witnesses this morning. SEC Chairman Breeden has taken hold quickly, and he has expressed on several occasions to me and others his total commitment to a very strong enforcement program. I think the steps that he has been taking in the early days of this job bear that out. This bill will assist him in that effort.

As the new Chairman of the SEC, one of his first acts has been to create a bank and thrift fraud unit within the division of enforcement. I want you to know, I and the whole committee applaud that initiative, in the wake of the thrift crisis. It is important that the disclosure statements of all financial institutions be very carefully monitored, and abuses both prevented and, when they occur, remedied.

I, too, want to welcome Bill McLucas, who is accompanying Mr. Breeden, in his first appearance before the committee, who is the new Director of the Enforcement Division. Mr. McLucas has many friends here. We look forward to working with him.

Just with respect to our second panel, certainly Judge Sporkin needs no introduction. No one was ever more aggressive in pursuing wrongdoing at the Commission, which was a great national service. I think Gary Lynch has also gone down in the history books, along with Judge Sporkin, for his leadership of the SEC's Division of Enforcement. And Aulana Peters was the first Commissioner, to the best of my recollection, to aggressively raise a number of the issues that we will be considering this morning.

So, Mr. Chairman, I think with these witnesses helping us, we ought to be able to draft constructive legislation in the enforcement remedies area. I very much look forward to their comments, and give to you and the subcommittee my pledge that, as soon as you are ready to move ahead at the full committee level, we will have the track cleared for you.

Senator DODD. Thank you very much, Mr. Chairman. I appreciate those words of support. We will try and move as quickly and thoughtfully as we possibly can.

Senator D'Amato.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, it is a pleasure for me to join you in welcoming Mr. Breeden. And I want to compliment our new Chairman for hitting the ground running. He really is.

And I want to take this opportunity to commend you and our ranking member, Senator Heinz, for your thoughtfulness and for your sponsorship of the legislation dealing with the Securities Enforcement Remedies Act, S. 647.

Upon initial review, it is an attractive piece of legislation. I am particularly drawn to the provisions which provide for real penalties, genuine deterrence to the type of manipulations that we experience today that modern technology and that modern stock practices make possible. I refer, of course, to the potential for market manipulation in index arbitrage, which I hope Mr. Breeden and others will continue to study and make comments on.

Surely, market manipulation can be as insidious a practice as insider trading. And I think the SEC should have the necessary tools to both identify and punish those who engage in it.

That is why I want to commend you, Mr. Chairman, and Senator Heinz, for introducing this legislation and for convening this hearing on this very important topic.

Finally, I would like to commend Chairman Breeden for instituting the SEC's new penny stock cold calling rule. That, Mr. Breeden, is long overdue, to protect widows, to protect the elderly, to protect people who are drawn by these boilerplate operations and who are sold this penny stock that all too often is absolutely worthless. It is a scam, or at best they should not be investing their life savings in some of the speculative kinds of stocks, given the nature of the stock. So let me commend you for undertaking this action.

Mr. Chairman, I, too, would like to join Chairman Riegle in commending you and the ranking member for your leadership not only at this hearing, but last year. And I look forward to a very constructive session this year, with you demonstrating the kind of leadership that is so necessary, and with the leadership of Chairman Breeden.

Senator DODD. Thank you very much, Senator.

I would be remiss if I did not point out that it was under your leadership 6 years ago that the first insider trading sanctions act was passed to impose civil penalties. That really set the ground for what we are doing here today, and hopefully what will get done. So I commend you for your actions when you chaired this subcommittee, for that legislation.

Senator D'AMATO. Thank you, Mr. Chairman.

Senator DODD. Before we begin I have a statement of Senator Sasser.

PREPARED STATEMENT OF SENATOR SASSER

Mr. Chairman, I wish to compliment you and Senator Heinz on your important legislation, the "Securities Law Enforcement Remedies Act of 1989," as well as your commitment in holding this hearing. I fully agree that the SEC needs enhanced enforcement authority, particularly the ability to impose fines in civil actions.

Indeed, I am increasingly disburbed by the scope of violations of our securities laws and believe that the SEC needs the proper tools to deal them. I think that we need to get about the business of enacting further refinements, and closing loopholes, in our securities laws, so I would hope that the SEC would have the "iron fist" to enforce such changes.

I think that many of the developments that have occurred in our securities markets over the past ten years have had a negative impact on American business and its employees, as well as the competitive position of America worldwide. Our companies have been beset by hostile raider "quick buck" artists that have abused and often violated our laws. Our major companies are more focussed on the raider that may be lurking over their shoulder than they are in making needed investments in research and development.

So Mr. Chairman, I'm all for a strong SEC to the extent that it can vigorously enforce the law, and return our securities markets to an atmosphere where people will invest for the long-term.

Thank you, Mr. Chairman.

Senator DODD. Chairman Breeden, welcome.

This is your first official appearance as Chairman of the SEC. Let me say how much I personally appreciate the kind of attention you have paid to the Hill. These things are not often known, but let me share with the visitors to the hearing room today that I think for a good 2 hours yesterday you and members of your staff and I sat in my office and covered the waterfront. I appreciate that kind of willingness to sit down and privately, as well as publicly, go over issues of importance to all of us. So I thank you for that kind of effort.

I commend you as well, as I have said in my opening statement, for the appointments that you have made. Mr. McLucas is a tremendously fine choice, and really does carry on the tradition that Senator Riegle has pointed out, with Stan Sporkin and Gary Lynch in the Enforcement Division. That is a tremendous tradition to maintain.

We will be glad to receive your testimony. I know your testimony is long. [Laughter.]

In order to maintain your good relations with the Hill, you are not going to have to read every word of that. [Laughter.]

I guarantee that we are going to make it a part of the record, every dotted "i" and crossed "t." But we respect your extemporaneous abilities to be able to paraphrase what you have included in those remarks.

I would add that everyone's testimony will be included in the record in full this morning.

Chairman Breeden.

STATEMENT OF RICHARD C. BREEDEN, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, DC

Mr. **Breeden**. Chairman Dodd, members of the subcommittee, I have some good news, and some bad news. The good news is that I do have a summary of my testimony. The bad news is, I might diverge from it and get carried away. But I hope you will keep me in the bounds of our time here this morning.

I would first like to simply respond to your very kind comments about working with you and the other members of the subcommittee and the committee. I would just indicate that at the Commission we regard the role of Congress, and I certainly regard personally the role of Congress, as absolutely critical in framing policies that would help us modernize a statutory framework which has done yeoman's service over the last half-century, but which is now faced with dramatically different operating conditions in the markets themselves.

I can think of no better way to spend the time. I certainly know we appreciate very much your willingness, and that of all the members of the committee, to work with the Commission to take these issues as seriously as we believe they merit, and that we can work together in a full exchange of views to try and come up with what I think we are all interested in, which is the best framework of laws that we can achieve to help our markets move forward into stability and competitiveness, and to protect investors.

I certainly appreciate the opportunity to work with you. And you gave me that opportunity, as did Senator Riegle, Senator Heinz, Senator D'Amato, and other members of this committee. I certainly appreciate that.

I welcome this opportunity to testify on behalf of the Securities and Exchange Commission concerning S. 647, the Securities Law Enforcement Remedies Act. As you mentioned, this is my first testimony before the Senate as Chairman of the Securities and Exchange Commission, and it is a distinct honor and privilege to appear before this subcommittee.

I might add that I cannot think of any subject on which it would be more appropriate for me to make my initial appearance before the Senate.

I appreciate the support that you, Chairman Dodd and Senator Heinz, have shown to the Commission in sponsoring S. 647. And I, along with the Commission, look forward to working with the subcommittee and the full committee on this important legislative initiative.

There is not any responsibility of the Commission that is more important than the protection of investors. This fundamental objective is critical to maintaining stability in our securities markets, and also preserving confidence in the integrity, fairness, and efficiency of these markets.

Individual investors in particular must be assured that the Commission has the will, the resources, and the legal remedies needed to enforce the Federal securities laws that were passed for their protection.

I would hope that no one would question that the Commission has the will to enforce the Federal securities laws in a vigorous and effective manner. Anyone who doubts our will, I would predict, will be sorry in the long run for that doubt.

Happily, the Congress approved the President's request for a significant increase in the Commission's budgetary resources during this fiscal year, which is permitting us to add many new positions to our fraud prevention program. And as you so aptly pointed out, while we are very proud and I am very proud of Bill McLucas, our new Enforcement Director, it is important that the overall program, top to bottom, be adequately and effectively staffed.

I am also very pleased to note that President Bush has just recommended in his budget submitted this week for fiscal 1991 an additional 15 percent increase over our fiscal 1990 appropriation. If approved by Congress, this increase will enable the Commission to continue to strengthen our enforcement program.

I might add that, in addition to the absolute number in the budget, one item we have discussed before, and that I certainly appreciate the willingness of this committee to work on, is the question of the pay scales of the Commissions employees. We need to be competitive not just with the private sector, but also with the other Federal financial regulatory agencies, so that we can attract not just numbers of staff but the traditional high quality of staff that the Commission has always been able to attract, and which is really vital to our success in running an effective enforcement program.

Despite these positive developments, the legal remedies available to the Commission, once fraud or other violations of the securities laws have been discovered, have grown increasingly inadequate. As every member of this committee appreciates, the markets have changed enormously in the more than half-century since most of the basic remedies available to the Commission were enacted.

Today, we must achieve our enforcement goals in an international environment and in a multimarket environment. We must operate against individuals and groups that have enormous resources, and that are fully capable of moving quickly to avoid detection or to escape effective sanctions.

Today, we must be prepared to address complex, intermarket efforts to manipulate not just single securities, but baskets of stock, and sometimes the entire market as well. We must address financial reporting cases involving complex accounting issues, penny stock frauds, ponzi schemes, insider trading, and violations of critical standards and other regulations governing market professionals, because different cases require different responses.

The Commission must have a broad range of remedies at its disposal. It needs a remedial structure that is strong enough to deter serious fraudulent conduct, while remaining flexible enough to permit an appropriate response in each case.

In short, we must be able to make the punishment fit the crime. We must be able to move quickly to stop ongoing fraudulent or other violative activity, and to apply sanctions as quickly as possible following any violation of the law. The proposed legislation will provide us with that adaptability and strength.

As you are aware, S. 647 is based upon a legislative proposal originally submitted early last year. While the original submission was a good proposal, the Commission has concluded that the provisions of the original legislation should be revised and enhanced.

Accordingly, I am recommending today certain revisions to S. 647 for the subcommittee's consideration. The Commission's modified proposal, like the original form of S. 647, would authorize the Federal courts to order the payment of civil money penalties in addition to disgorgement for violations of the securities laws, other than insider trading where such authority already exists. The Commission's modified proposal also would authorize the Commission to impose civil penalties in administrative proceedings, but only in cases against registered entities and their associated persons.

The modified proposal also would expressly authorize the Commission to order disgorgement in its administrative proceedings, a feature not included in the original S. 647.

The Commission's legislation would expressly affirm the authority of the Federal district courts to prohibit individuals who have committed egregious violations of section 17(a)(1) of the Securities Act, or section 10(b) of the Exchange Act, from serving as officers or directors of any reporting company. This is narrower than the original provisions of S. 647, but the Commission does not believe that broader authority than this is necessary, since this remedy is appropriately used only in egregious cases of fraud. In addition, applying this sanction only in judicial proceedings, rather than by administrative action, may also provide a somewhat better balance in applying this particular sanction.

The Commission's amended proposal would contain new provisions authorizing the Commission to issue cease and desist orders for violations of the securities law. This cease and desist authority would make an administrative forum available in virtually all cases within the Commission's jurisdiction. Each of the other Federal financial regulatory agencies, including the Federal Reserve, the OCC, the FDIC, the OTS, and the CFTC, already has the power to issue this type of order. Cease and desist powers are also widely used by other types of agencies, including the EPA, the FAA, and a number of other agencies. The respondent in any such action will receive notice of the charges, and will have an opportunity to contest any such order in the full administrative hearing process, as well as to seek review of the Commission's actions ultimately before a U.S. court of appeals.

Today, the Commission often faces significant delays in bringing cases before a Federal judge. The new provisions would also allow the Commission to issue temporary cease and desist orders pending an administrative hearing in emergency situations. This procedure would be available when the Commission determines that a violation is likely to cause dissipation of assets, conversion of property, or significant harm to investors, or is otherwise likely to result in substantial harm to the public prior to the time in which a permanent cease and desist proceeding could be completed.

This remedy could be used, for example, to immediately halt a massive violation of cold calling restrictions when the Commission discovered a suspected ongoing penny stock swindle. Today, such practices could continue for a significant time, with more investors getting defrauded while proceedings were dragged out in court.

Any such temporary cease and desist order would be effective upon service on the respondent. The respondent could seek review of the temporary order in Federal district court within 10 days of service, but the temporary order would be effective unless the court or the Commission stayed or suspended it.

Under the Commission's proposal, the failure to comply with the cease and desist order would be punishable by civil penalties, which could be obtained in addition to a court order directing compliance and disgorgement. This would replace what is today a cumbersome, two-step contempt process.

Where there is an ongoing violation of net capital rules, customer security segregation requirements, accounting fraud, or other such matters, delays in bringing proceedings before the Federal courts under today's processes can adversely affect investors.

In addition, the cease and desist procedure would help relieve the district court dockets of some of the more complex regulatory proceedings, while of course maintaining overall judicial review.

The original S. 647 contained provisions that would authorize the Commission to impose money penalties in administrative proceedings brought under section 15(c)(4) of the Exchange Act, and that would have expanded the scope of section 15(c)(4) to include violations of section 16(a) of the Exchange Act.

In light of its recommendations, that Congress should provide more comprehensive and flexible cease and desist remedies, the Commission does not believe that these amendments to section 15(c)(4) are necessary. The prospect of court enforcement and court ordered money penalties for violations of the cease and desist orders should provide adequate deterrence against repeat violations by respondents in the types of financial reporting accounting cases the Commission would have brought under the originally proposed revisions to section 15(c)(4).

The proposed cease and desist authority would also provide a remedy to deal with the serious problem posed by widespread and repeated noncompliance with section 16(a), as the Commission will be able to proceed administratively against delinquent filers.

Finally, the Commission's legislation, unlike S. 647, would amend the Federal Criminal Code to authorize a court to permit disclosure to the Commission of grand jury information concerning a potential securities laws violation, for use in matters within the Commission's jurisdiction.

This provision is modeled on a similar provision in the FIRREA legislation. It granted the Federal banking agencies similar access to Federal grand jury information. This would be a significant benefit to the Commission. Frequently, our largest and most far-reaching cases involve parallel criminal investigations. These criminal investigations are typically assisted by Commission personnel; yet, even after the criminal process is completed, under current law the Commission cannot have access to information relevant to our own enforcement proceeding, even when that information was developed by our own personnel.

This can give deliberate violators in both civil and criminal proceedings a significant benefit by preventing all the evidence known to the U.S. Government from being used in all the related enforcement proceedings.

Each of the provisions in the Commission's amended proposal would strengthen our enforcement program. Fining authority would certainly improve deterrence by raising the economic stakes for securities law violators. Today, we have a problem, in that orders of disgorgement, the economic penalty which is most typically applied, merely require a violator to return illicit profits.

That of course creates a situation in which the violator, if he goes undetected, keeps all the profits. But if he is detected in the violation and is successfully prosecuted, the maximum liability economically is to return all the ill-gotten gains. It is a little bit similar to the "heads, I win, tails, you lose" problem that was seen in the thrift industry prior to the action by Congress to dramatically strengthen the capital rules.

We would like to change the equation of those who are contemplating a deliberate violation of the law, so that the consequences of detection and of successful prosecution will leave such individuals in a worse position than they would have been in, not simply in the same position as if they had never attempted the violation.

This penalty provision will also give the Commission more flexibility to tailor a remedy to the gravity of the violation. Sometimes, there are cases where we cannot prove that specific investors had been defrauded, or cannot prove specific unjust enrichment, if you will, in order to apply disgorgement remedies, but where there has nonetheless been an extremely serious violation of the securities laws that may have put large numbers of people at risk.

It is important that we be able to have a remedy, even where we cannot demonstrate that there has been a significant profit to the individual or organization that violated the law.

Today, the Commission often must choose, particularly in applying administrative proceedings to regulated persons and entities, between a censure, which can often be seen as a mere slap on the wrist, and outright suspension of the firm or individual, remedies that in many cases may be either too weak on the one hand, or too severe on the other. What we have today is the ability to deliver a pin-prick or to deliver the atom bomb. I would like to see us have some remedies in between.

Disgorgement authority in administrative proceedings would also make sure that respondents cannot retain illicit profits. The proposed cease and desist authority, similar to that exercised by the other Federal agencies, would provide us, again, with flexibility in using remedies in cases appropriately brought in an administrative forum.

The power to enter, as I suggested, a temporary cease and desist order offers us the ability to respond to ongoing violations that may not warrant the temporary restraining order in Federal district court, or where we might find it difficult to get before a court to get such relief, but that nonetheless expose investors to significant risk of loss.

Continuing violations, for example, of the capital rules or of customer security segregation requirements, would be ideally suited to application of the cease and desist order.

The affirmation of judicial authority to impose corporate bars for certain types of fraud would also resolve any doubts about the propriety of this remedy. The Commission has obtained it in the past, and we intend to seek it in the future against defendants who have demonstrated a flagrant propensity to abuse a position of corporate trust.

Finally, the proposal for increased disclosure of grand jury information to the Commission would be of enormous assistance to several investigations, and would avoid unnecessary duplication of efforts. It would avoid giving defendants in the most serious cases undue advantage and benefit.

In closing, let me emphasize once again that the Commission is dedicated to the goal of protecting the integrity and the stability of the Nation's securities markets, and the vital ability to raise equity capital. With the Commission's proposed changes, this legislation would provide the tools necessary to act in a strong, timely, yet flexible manner.

At the same time, it is very important that we give careful consideration to the overall balance and fairness in application of the Commission's enforcement remedies. The processes and procedures used by the Commission must operate fairly and permit the opportunity for a vigorous defense.

While this legislation would add to the Commission's authority, I do believe it would preserve that critical balance between the ability of the Commission to protect the public interest and the ability of those accused of wrongdoing to have a full and fair opportunity to defend themselves.

The Commission therefore urges prompt consideration and enactment of this vital legislation.

Thank you very much.

[The complete prepared and executive statements of Richard C. Breeden follow:]

STATEMENT OF RICHARD C. BREEDEN, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, BEFORE THE SUBCOMMITTEE ON SECURITIES OF THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

CONCERNING S. 647, THE "SECURITIES LAW ENFORCEMENT REMEDIES ACT OF 1989"

I. INTRODUCTION

Chairman Dodd and Members of the Subcommittee:

I welcome this opportunity to testify on behalf of the Securities and Exchange Commission concerning S. 647, the "Securities Law Enforcement Remedies Act of 1989." This is my first opportunity to testify as Chairman before the Senate, and it is a distinct honor and privilege to appear before this Subcommittee. The Commission appreciates the support of Chairman Dodd and Senator Heinz in sponsoring S. 647, and we look forward to working with the Subcommittee on this important legislative initiative.

The Commission is committed to maintaining an aggressive and comprehensive program to enforce the federal securities laws. An effective enforcement program is necessary to protect investors and to preserve confidence in the integrity, fairness, and efficiency of our securities markets. It is especially important that small investors do not abandon our markets because they perceive that the federal government is unwilling to dedicate the resources necessary to protect them against unfair practices. Individual investors, in particular, must be assured that the Commission has the will, the resources, and the legal remedies needed to enforce the securities laws that were passed for their protection.

In order to ensure that the Commission will continue to operate effectively and to have the capacity to deal with emerging enforcement problems, I have recently allocated approximately 100 additional positions to the Commission's fraud prevention program for fiscal years 1990 and 1991. This allocation assumes enactment of the increased budget of $192.4 million that the President has recommended for the Commission in fiscal 1991, a 15% increase over the appropriation available during fiscal 1990. Congress approved the President's request for fiscal 1990, and that action has already provided the resources for a significant increase in the Commission's enforcement program. Because a system of regulation cannot be adequate unless it is backed by sufficient resources, it is gratifying that the President has requested Congress to provide this significant increase in resources, which will permit the Commission to continue strengthening its enforcement and other critical programs.

The Commission's enforcement program must deal with a wide range of securities law violations. Its principal program areas include financial reporting violations and accounting fraud; insider trading; penny stock fraud; violations of the tender offer and proxy provisions; market manipulation; fraud in the offer and sale of securities; and violations of the standards governing market professionals. Given the disparate nature of these cases, the Commission must have a range of remedies that enables it to act in a flexible manner. Achieving the appropriate level of deterrence in each case is important in maximizing the remedial effect of the Commission's enforcement actions. The proposed legislation will be of material assistance to the Commission in achieving that goal.

S. 647 is based upon a legislative proposal originally submitted by the Commission to Congress in January 1989. After a careful review of the bill and the problems that the Commission faces in its enforcement program, the Commission has concluded that the provisions of the original legislation should be enhanced. [1] Accordingly, I am recommending today certain revisions to S. 647 for the Subcommittee's consideration. With these revisions, the legislation would amend the federal securities laws to:

- authorize the federal courts to order the payment of civil money penalties, in addition to disgorgement, for violations of the federal securities laws;
- authorize the Commission to order disgorgement and impose civil penalties in certain administrative proceedings under the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940;
- authorize the Commission to issue cease-and-desist orders for violations of the securities laws; and
- expressly affirm the inherent authority of the federal district courts, in connection with injunctive actions brought by the Commission, to issue orders that prohibit individuals who have committed egregious violations of Section 17(a)(1) of the Securities Act of 1933 or Section 10(b) of the Exchange Act from serving as officers or directors of any reporting company.

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[1] Commissioner Fleischman concurs in these legislative recommendations only with respect to the subject matter of Parts III.B, V.C and VI hereof.

In addition, the proposal would amend the Federal Criminal Code to authorize a court to issue an order permitting disclosure to the Commission of grand jury information concerning potential securities law violations for use in matters within the Commission's jurisdiction, just as Congress provided such authority for the banking agencies in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"). [2]

As discussed in detail below, the Commission's revised proposal differs from S. 647 as introduced in five respects. First, unlike S. 647, the revised proposal would expressly authorize the Commission to issue cease-and-desist orders for violations of the federal securities laws. Second, the revised proposal would expressly authorize the Commission to order disgorgement of illegal profits in its administrative proceedings against regulated entities and in its cease-and-desist proceedings. Third, the revised proposal would provide that the express authority of the federal courts to bar securities law violators from serving as officers or directors of reporting companies be limited to cases involving violations of certain scienter-based fraud provisions. Fourth, because the revised proposal contains cease-and-desist authority, it would not contain the amendments to Section 15(c)(4) of the Exchange Act found in S. 647. These provisions of S. 647 would provide for civil money penalties and officer-and-director bars in Section 15(c)(4) proceedings and would expand the bases for these proceedings to include violations of Section 16(a) of the Exchange Act. Fifth, the revised proposal's provision relating to grand jury information is not in S. 647.

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[2] Pub. L. No. 101-73, § 964(a), 103 Stat. 183, 505 (1989).

The need for each of these provisions is discussed below.

II. NEED FOR CIVIL MONEY PENALTIES

The Commodity Futures Trading Commission ("CFTC"), the Federal Deposit Insurance Corporation ("FDIC"), the Comptroller of the Currency ("OCC"), the Federal Reserve System ("FRS"), the Office of Thrift Supervision ("OTS"), and virtually all other federal regulatory agencies have the statutory authority to seek or impose civil money penalties. As stated in a report to the Administrative Conference of the United States,

> [t]he civil fine has assumed a place of paramount importance in the compliance arsenal of most federal regulatory agencies. It is today almost inconceivable that Congress would authorize a major administrative regulatory program without empowering the enforcing agency to impose civil monetary penalties as a sanction. It has become commonplace for observers of the administrative process, disillusioned with traditional criminal, injunctive and license-removal sanctions, to urge greater reliance on civil fines as an enforcement device.[3]

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[3] Colin S. Diver, Report to the Administrative Conference of the United States Concerning the Assessment and Mitigation of Civil Money Penalties by Federal Administrative Agencies 1 (May 1979).

Just six months ago, Congress, outraged by widespread fraud in the banking and savings and loan industries, responded to the President's call for action by authorizing a substantial increase in the civil money penalties for violations of the banking laws. The provisions of FIRREA now authorize civil money penalties ranging as high as $1 million per day. [4]

The Commission's statutory authority to employ this widely accepted remedy is very limited. Under current law, the Commission has the authority to seek civil money penalties for only three types of violations. Most significantly, Section 21A of the Exchange Act provides that the Commission may seek a civil penalty against any person who has violated the Exchange Act by engaging in insider trading offenses, or against any person who controls a person engaging in insider trading offenses. [5] The authority to seek civil money penalties in insider trading cases was first provided to the Commission in the Insider Trading Sanctions Act of 1984 ("ITSA").[6]

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[4] See, e.g., 12 U.S.C. 1818(i)(2).

[5] The other two civil penalty provisions apply to a very limited number of cases. First, by reason of recent amendments to the Foreign Corrupt Practices Act, enacted as part of the Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, 102 Stat. 1107,~~ 1415 (19~~88) (amending Section 32(c) of the Exchange Act, 15 U.S.C. 78ff(c)), the Commission may seek a civil money penalty not to exceed $10,000 against an issuer, or certain persons acting on behalf of an issuer, who violates Section 30A(a) of the Exchange Act. Second, under Section 32(b) of the Exchange Act, issuers may be assessed a civil penalty of $100 per day for failure to file certain required information. See 15 U.S.C. 78ff(c). The Commission is aware of only one case in which a penalty of any kind was collected under Section 32(b). See United States v. Mercantile Properties, Inc., Lit. Release No. 360 (S.D.N.Y. August 27, 1946)($10,000 accepted to settle proceeding against issuer that was approximately 500 days in default).

The Commission recommended that Congress enact ITSA because it had concluded that civil money penalties were necessary to deter insider trading violations, given the difficulty of detecting such violations and the large profits that could be derived from them. The Commission's experience with civil money penalties in the insider trading area has been extremely positive. In the five year period since ITSA was enacted, the Commission has obtained more than $95 million in civil money penalties under the Act. The Commission also has found that it is possible to obtain substantial penalties even when cases are settled, and that the availability of this remedy has not had adverse consequences for its enforcement program.[7]

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[6] The civil money penalty provisions of ITSA were recodified in new Section 21A with the enactment of the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704. Under Section 21A, the amount of the penalty imposed on the person committing the violation may not exceed three times the profit gained or loss avoided as a result of the violation; the penalty imposed upon a controlling person may not exceed the greater of $1 million or three times the controlled person's profit or loss.

[7] It should be noted, however, that a Supreme Court decision subsequent to the enactment of ITSA has held that a defendant has the right to a jury trial in court cases where the government seeks a monetary penalty. See Tull v. United States, 481 U.S. 412 (1987). The Commission has tried one insider trading case before a jury, and was successful in that case. SEC v. Clark, 699 F. Supp. 839 (W.D. Wash. 1988), appeal docketed, No. 89-35486 (9th Cir. 1989). To the extent that jury trials are more complex and require a larger commitment of resources, the authority to seek civil money penalties would likely require the Commission to devote a greater percentage of its enforcement resources to litigation, as opposed to investigations.

The Commission therefore believes that the benefits of comprehensive civil fining authority would greatly exceed any potential costs. By authorizing money penalties for violations of the federal securities laws other than insider trading, the proposed legislation would greatly increase deterrence, while also providing both the Commission and the courts with the flexibility to tailor a remedy to the gravity of a violation.

A. Increased Deterrence

The Commission believes that the money penalties proposed in this legislation are needed to provide financial disincentives to securities law violations other than insider trading. Many violations of the securities laws, such as those involving penny stock fraud, market manipulation, and fraudulent financial reporting, may be enormously lucrative to the violator. Absent a criminal prosecution or a private suit for damages, however, even the defendant who makes a deliberate decision to violate the law and causes significant harm to the markets does not risk any monetary sanction more severe than an order of disgorgement. Since disgorgement merely requires the return of wrongfully obtained profits, it does not result in any actual economic penalty. If the violator avoids detection, he is able to keep the profits resulting from illicit activities. At present, even if the violator is caught, he is required merely to give back his gains, leaving him no worse off than he would have been if he had chosen not to violate the law. The Commission therefore believes that authority to seek or impose substantial money penalties, in addition to the disgorgement of profits, is necessary for the deterrence of securities law violations that otherwise would provide great financial returns to the violator.

The proposed civil money penalties would also provide a financial disincentive to violations that reflect an unwillingness to incur the cost of full compliance with the securities laws, as opposed to a conscious intent to defraud investors. A broker-dealer or an investment company may fail to comply with regulatory requirements simply because it is unwilling to devote the resources necessary to comply with these statutory objectives. As examples, violations of bookkeeping provisions or the Commission's customer protection rule, which requires that customers' fully paid and excess margin securities be maintained in a separate account, may occur without a specific intent to defraud even though they expose customers to a serious risk of loss. To the extent that such violations are motivated by a desire to maximize profits by reducing costs, the prospect of civil money penalties will improve compliance with the law and have a significant remedial effect.

Finally, the proposed fining authority would enable the Commission to deal more effectively with the problem of recidivist violators. The Commission increasingly has been confronted with persons who violate the securities laws after they have already been sanctioned for the same or similar conduct. [8]

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[8] Based on a review of Commission administrative and court actions, for example, it appears that the Commission has brought at least 55 cases since 1980 against persons who previously had been the subject of an unrelated Commission enforcement action. In addition to those cases, the Commission has brought (continued...)

The extent of recidivism reflects the inadequacy of the Commission's current remedial authority. If a respondent engages in conduct that violates a Commission administrative order, the Commission's only remedy is to seek a mandatory injunction directing compliance with its order. Moreover, although a defendant who violates a court injunction may be prosecuted in a criminal contempt action, the criminal standard of proof is difficult to meet, and the contempt remedy does not address unlawful conduct that is outside the scope of the injunction.

Providing authority to seek or impose civil money penalties would address the problem of recidivism by increasing the costs associated with repeated securities law violations. Both the Commission and the courts could take prior violations into account when imposing civil money penalties, thereby achieving greater deterrence against violators who are not deterred by the civil and administrative remedies currently available.

B. Increased Flexibility

In addition to increasing deterrence, a civil money penalty would provide both the courts and the Commission with greater flexibility to tailor a remedy to the

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[8] (...continued) over 50 civil or criminal contempt actions since 1986 against persons who have violated the terms of judicial decrees. These statistics greatly understate the extent of recidivism. They do not include enforcement actions brought against persons whose prior violations were the subject of proceedings brought by criminal authorities, self-regulatory organizations, or state securities commissions. They also do not include cases brought against persons whose prior violations were the subject of private actions.

seriousness of the violation. This flexibility would be especially helpful to the Commission in its administrative proceedings against registered broker-dealers and other regulated entities. Current law provides that, where the Commission finds that a broker-dealer has willfully violated the securities laws, it may impose remedial sanctions ranging from a censure to a revocation of the firm's registration. In practice, however, the Commission often must choose between remedies that are either too weak or too severe.

For many firms, a censure provides relatively little deterrence against future violations. However, it often is impossible to revoke the firm's registration, or even to suspend its operations temporarily, without causing severe hardship to the firm's customers, public shareholders, and innocent employees. If the Commission had the option of imposing a monetary penalty, it could appropriately sanction misconduct requiring a penalty more severe than a slap on the wrist, but where a suspension or a revocation would have unwarranted adverse consequences. [9]

The Commission would not, of course, seek or impose a civil money penalty in every case. Where a failure to comply with Commission requirements involves isolated or unintentional conduct, the implementation of new procedures or a similar remedial measure will often be the most appropriate resolution of the case. At the other end of the spectrum, where the defendant in a Commission action is also the subject of a criminal prosecution, the imposition of a civil money penalty in the Commission's action may not be needed to achieve deterrence.[10] The Commission does not recommend that fining authority be limited to cases involving intentional or fraudulent conduct. Disregard of the customer protection rules, the broker-dealer net capital rules, or repeated violations of recordkeeping requirements would warrant monetary penalties. Many other agencies have penalty authority with respect to conduct such as the failure to file reports, keep records, permit entry, or respond to agency inquiries.[11] For example, the Federal Railway Safety Act authorizes the Secretary of Transportation to assess a civil penalty with a general maximum of $10,000 against any railroad or railroad employee or agent for any violation under that act.[12] The Tariff Act of 1930 provides a civil penalty for the failure, including the failure due to negligence, to declare any article required to be declared under U.S. customs law. [13]

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[9] As long ago as 1972, a Commission Advisory Committee on Enforcement Policies and Practices ("the Wells Committee") recommended that the Commission consider the use of civil money penalties in broker-dealer proceedings. See Report of the Advisory Committee on Enforcement Policies and Practices (June 1, 1972). The Committee's Report suggested that "the availability of money penalties would provide the Commission with substantially greater flexibility in fashioning a suitable remedy for this type of proceeding." Id. at 46.

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[10] It should be noted that, in United States v. Halper, 109 Sup. Ct. 1892 (1989), the Supreme Court held that the imposition of a substantial civil money penalty pursuant to the False Claims Act against a defendant who already had sustained a criminal penalty for the same conduct violated the double jeopardy clause of the Constitution. If the holding in Halper were extended to actions brought by the Commission under this proposed legislation, the Commission might have to forego a civil money penalty in certain cases.

[11] See Diver, The Assessment and Mitigation of Civil Money Penalties by Federal Administrative Agencies, 79 Colum. L. Rev. 1435, 1438 (1979).

[12] 45 U.S.C. 438. Such a penalty may be assessed for any rule, regulation, order, or standard issued under the act, including those relating to recordkeeping (continued...)

While fines should be available for cases beyond fraudulent and intentional conduct, it may also be desirable to establish categories of offenses for purposes of determining the level of fines that could be imposed. Congress established three different "tiers" of violations under FIRREA, with substantially different maximum fines depending on the tier of a given violation. The Commission will be pleased to work with the Congress if it is deemed desirable and appropriate to establish similar categories of offenses that would involve different maximum fines. These categories could apply both in administrative proceedings and in judicial actions.

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[12] (...continued)
requirements. Repeated or grossly negligent violations may be fined up to $20,000 per violation. In addition, recordkeeping violations such as a knowing or willful false entry or omission of information in a required record or report may be subject to criminal penalties of up to $5,000 and two years imprisonment for each violation. See 45 U.S.C. 438(e).
The Secretary of Transportation is also authorized to impose penalties of up to $1,000 per violation or $800,000 for a related series of violations for the manufacture, sale, delivery or importation of sub-standard motor vehicles. See National Traffic and Motor Vehicle Safety Act, 15 U.S.C. 1398.

[13] 19 U.S.C. 1497(a). The penalty consists of forfeiture of the article plus a fine equal to the value of the article, or, if the article is a controlled substance, ten times its value. Id.

III. ADMINISTRATIVE PROCEEDINGS

A. Penalties in Administrative Proceedings

The proposed legislation would authorize the Commission to impose money penalties in administrative proceedings against registered entities or individuals by adding new provisions to the Exchange Act (new Section 21B), the Investment Company Act (new Section 9(d)), and the Investment Advisers Act (new Section 203(i)).[14] These provisions would authorize the Commission to impose monetary penalties in proceedings brought under Sections 15(b), 15B, 15C, and 17A of the Exchange Act, under Section 9(b) of the Investment Company Act, and under Sections 203(e) and 203(f) of the Investment Advisers Act. The proposed fining authority would not extend to administrative proceedings brought against professionals under Rule 2(e) of the Commission's Rules of Practice.

S. 647 in its original form also contained provisions that would authorize the Commission to impose civil money penalties in administrative proceedings brought under Section 15(c)(4) of the Exchange Act. As discussed later in this testimony, the Commission does not believe that amendments to Section 15(c)(4), as proposed in S. 647, would be necessary if Congress provided a cease-and-desist remedy which includes court-imposed civil money penalties for noncompliance.

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[14] See proposed legislation at Sections 202, 301, and 401.

The administrative fining provisions would not specify a fixed penalty for each violation. The Commission believes that variable penalty provisions are preferable to fixed penalties because they would permit the Commission to tailor the size of civil monetary penalties to fit the circumstances of individual cases. In addition, fixed penalties generally are most suitable where the penalty amounts are smaller than those contemplated here.

The penalty provisions of the proposed legislation would set the maximum amounts for penalties assessed by the Commission at $100,000 per violation committed by a natural person, and $500,000 per violation committed by any other person. This authority would be comparable to the authority provided to the CFTC, which may assess penalties up to $100,000 for manipulation or fraud in the commodities market.[15] While this amount should be sufficient to deter violations of the federal securities laws by an individual, the Commission believes that it would be too low to provide adequate deterrence against violations by non-natural persons. In view of the financial scale of the enterprises which the Commission regulates, the

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[15] See 7 U.S.C. 9. As discussed above, another example of broad fining authority may be found in the provisions of FIRREA. In a significant expansion of previous civil money penalty liability under existing banking statutes, FIRREA establishes penalties in tiered amounts of $5,000, $25,000 and $1 million per day depending upon the scope and severity of the misconduct. An agency may assess the maximum penalty of $1 million per day against an institution which, or party who, knowingly commits a violation, engages in an unsafe or unsound practice, or breaches any fiduciary duty and knowingly or recklessly causes a substantial loss to the institution or substantial pecuniary gain to the party through the violation. See, e.g., 12 U.S.C. 1818(i)(2) (as amended by FIRREA).

Commission recommends that the maximum fine against such entities be established at $500,000 per violation.[16]

The proposed legislation would authorize the Commission to impose a penalty if it finds, on the record after notice and opportunity for hearing, that a person has committed a violation, and that a penalty is in the public interest. Each of the provisions for penalties in administrative proceedings would state that "[i]n considering * * * whether a penalty is in the public interest, the Commission may consider" the following factors:

1. whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;
2. the harm to other persons resulting either directly or indirectly from such act or omission;
3. the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior;
4. whether such person previously has been found by the Commission, other appropriate regulatory agency, or self-regulatory organization to have violated the federal securities laws, state securities laws, or the rules of a self-regulatory organization, or has been enjoined by a court of competent jurisdiction from violations of such laws or rules, or has been convicted of certain securities-related offenses;

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[16] The Commission expects that it would bring civil actions in federal court in those cases in which defendants have received illegal gains substantially in excess of these maximum amounts. As discussed below, under the legislation the maximum civil money penalty that a court could impose would be the greater of the specified amounts or "the gross amount of pecuniary gain to such defendant as a result of the violation."

5. the need to deter such person and other persons from committing such acts or omissions; and

6. such other matters as justice may require.

The six factors that would govern penalty assessments in administrative proceedings generally reflect the type of analysis that the Commission makes in determining appropriate remedies under its current enforcement policy. The Commission selected these factors after reviewing penalty provisions in other federal statutes and considering the many variables involved in penalty assessment. The Commission believes that the proposed standards are appropriately precise without being overly rigid.

The Commission also believes that the ability of respondents to pay a civil penalty is an important consideration that respondents should be permitted to address. The statutory provisions would make it clear that respondents could present evidence about their ability to pay, and the Commission would be able to consider this point in determining what sanction is in the public interest.

Commission orders imposing a money penalty, like orders imposing any other remedial sanction in an administrative proceeding, could be appealed to the U.S. court of appeals for the circuit in which the respondent resides or has his principal place of business, or for the District of Columbia Circuit. Thus, while the proposed legislation would empower the Commission to impose civil money penalties in certain of its administrative proceedings, its use of this sanction would be subject to judicial review in each case.

B. Disgorgement Orders in Administrative Proceedings

The proposed legislation would also provide that the Commission may enter disgorgement orders in its administrative proceedings.[17] The Commission does not have express authority to order disgorgement under current law, although it sometimes conditions its sanction upon the respondent's compliance with an undertaking to disgorge profits or make restitution to injured customers.[18] In other words, the Commission today may suspend a respondent based on the respondent's representation that it will disgorge profits or make restitution, while reserving the right to impose a more severe sanction if the respondent fails to do so.

The proposed legislation would make the extent to which a respondent has made restitution one of the factors governing the imposition of administrative fines. This will provide a respondent with the incentive to return unlawfully derived profits even without an order of disgorgement. In order to ensure that respondents in administrative proceedings may not retain illicit profits, however, the Commission believes that it should have the express authority to order disgorgement in its administrative proceedings.[19]

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[17] See proposed legislation at Section 202 (new Section 21B(e) of the Exchange Act), Section 301 (new Section 9(e) of the Investment Company Act), and Section 401 (new Section 203(j) of the Investment Advisers Act).

[18] See, e.g., In the Matter of Anderson & Strudwick, Inc., Exchange Act Release No. 22089 (May 29, 1985); In the Matter of Thomson McKinnon Securities, Inc., Exchange Act Release No. 21668 (January 17, 1985).

IV. PENALTIES IN CIVIL ACTIONS

In addition to authorizing the Commission to impose money penalties in its own administrative proceedings, the proposed legislation would also authorize the Commission to seek court orders imposing civil money penalties against persons who have violated the federal securities laws.[20] These penalties could be imposed in addition to orders of disgorgement directing a defendant to return the full amount of profits derived from a violation. Where a civil money penalty is sought by the Commission, the district court would have discretion to determine whether a penalty should be imposed, and the amount of such penalty. This discretion would permit the court to impose a civil money penalty even if it determined that injunctive relief against the same defendant was not warranted.

The maximum penalty which a court could impose for each violation, in addition to an order of disgorgement, would be "the greater of (1) $100,000 for a natural person or $500,000 for any other person, or (2) the gross amount of pecuniary gain to such defendant as a result of the violation." [21] The court would determine the amount of the penalty "in light of the facts and circumstances," on a discretionary basis. Thus, in addition to ordering disgorgement of profits, a court could assess a civil penalty equal to a violator's gain, even when that gain exceeds the $100,000 and $500,000 limitations applicable to the Commission's administrative proceedings.

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[19] It is important to distinguish disgorgement from restitution or damages. In contrast to damages granted in private action, which are designed to compensate the victims of a violation, disgorgement "is a method of forcing a defendant to give up the amount by which he was unjustly enriched." SEC v. Blavin, 760 F.2d 706, 713 (6th Cir. 1985); SEC v. Commonwealth Chemical Securities, Inc., 574 F.2d 90, 102 (2d Cir. 1978).

[20] See proposed legislation at Sections 102, 201, 302, and 402.

By establishing these penalty provisions, Congress would be changing the "down-side" calculation for violations of the securities laws. Today, except for insider trading violations, the worst monetary remedy most violators are subject to is loss of profits from the illegal activity -- leaving the violator no worse off than if he or she had not committed the violation. This statute will make the maximum exposure of a violator more than the amount of any profit, thereby creating a significant pecuniary risk from a violation.

Although the Commission has recommended that its own authority to assess a penalty in an administrative proceeding should be subject to specific upper limits, it believes that the federal courts should have greater discretion. Under current law, a district court already may assess a civil penalty of up to three times the profits derived from an insider trading violation, no matter how large those profits may be, based upon "the facts and circumstances" of the case. This provision would extend the principle of ITSA penalties to other types of securities law violation.

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[21] The phrase "pecuniary gain" in this provision is borrowed from Section 3571 of the Federal Criminal Code, 18 U.S.C. 3571, which authorizes a court to impose a criminal fine of up to twice any person's gross pecuniary gain from an offense. Both the Commission and the courts have extensive experience in fashioning orders of disgorgement, which generally require the same type of analysis to determine the amount by which a defendant profited from securities law violations.

V. CEASE-AND-DESIST AUTHORITY

A. Need for Cease-and-Desist Authority

A cease-and-desist order is an administrative remedy that directs a person to refrain from engaging in further violative conduct. For many years, various federal agencies have been authorized to issue cease-and-desist orders against persons who have violated or are about to violate statutory provisions administered by those agencies. For example, the CFTC is authorized to issue cease-and-desist orders with respect to any person if it finds that the person has manipulated or attempted to manipulate the price of any commodity, or has violated any provision of the Commodity Exchange Act or the rules, regulations or orders of the Commission thereunder.[22] The Federal Trade Commission, the National Labor Relations Board, and each of the federal bank regulatory agencies also are empowered to issue cease-

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[22] See 7 U.S.C. 13(b).

and-desist orders. [23] Indeed, of all the federal financial regulatory agencies, only the Commission does not have express authority to issue a cease-and-desist order. Cease-and-desist authority permits swift remedial action in response to illegal conduct without having to meet the stringent standards necessary to obtain a temporary restraining order or other extraordinary emergency relief from an overburdened federal district court.

Because the Commission does not have any express authority under the federal securities laws to issue cease-and-desist orders, it typically deals with ongoing securities law violations by filing a civil injunctive action in federal district court. The Commission also has the option of proceeding administratively in cases involving misconduct by regulated entities or their associated persons. However, the Commission may not name persons who are not associated (or seeking to become associated) with a regulated entity as respondents in such proceedings.

The Commission has been successful in urging federal district courts to grant emergency relief, in the form of preliminary injunctions against further violations, temporary restraining orders, orders freezing assets, and the appointment of receivers. Not all infractions, however, warrant such extraordinary relief. Moreover, the congested nature of our federal court dockets is such that many of the Commission's injunctive actions are not tried until more than a year after they are filed.

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[23] Federal Trade Commission Act, 15 U.S.C. 45(a), (b) (deceptive trade practices); Labor-Management Relations Act, 29 U.S.C. 160(c) (unfair labor practices); Federal Deposit Insurance Act, 12 U.S.C. 1818(b) (as amended by FIRREA).

The availability of a more streamlined administrative procedure would permit the Commission to address specific violations more quickly and efficiently in circumstances where emergency judicial relief is not available. The Commission's staff might discover, for example, that a broker-dealer is soliciting business in violation of Exchange Act Rule 15c2-6, the "cold-calling" rule which the Commission recently adopted to combat penny stock fraud. A cease-and-desist remedy would permit the Commission to order cessation of such selling efforts by a firm or individual immediately without waiting for time on a crowded court docket to seek emergency relief in federal district court.

The proposed cease-and-desist authority would also benefit the Commission by providing it with a flexible administrative remedy that is comparable to an injunction. This would enable the Commission to address violations in a manner that recognizes different degrees of securities violations. Where the consequences collateral to an injunction are not necessary or appropriate, [24] the availability of a cease-and-desist order would permit the Commission to resolve cases without protracted negotiation or litigation. Such authority would also provide the Commission with an alternative remedy against persons who commit isolated infractions and present a lesser threat to investors.

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[24] These collateral effects might include the statutory disqualification of certain persons from serving as an officer or director of an investment company that is contained in Section 9(a)(2) of the Investment Company Act, or the possible institution of proceedings pursuant to Rule 2(e)(3) of the Commission's Rules of Practice against accountants and attorneys.

The proposed cease-and-desist authority would make an administrative forum available in virtually all cases within the Commission's jurisdiction. For example, if an issuer engaging in a self-underwritten offering of securities violated the broker-dealer registration provisions because its selling efforts were outside the safe-harbor provided by Exchange Act Rule 3a4-1, the Commission could enter a cease-and-desist order to immediately halt further sales. This administrative remedy could also be used to address unregistered offerings that violate Section 5 of the Securities Act.

The availability of an administrative remedy is important because of the significant delays that the Commission often faces in seeking a judicial remedy. Indeed, in some districts it can take one to three years for the Commission to get an enforcement case tried by the district court. By that time, many enforcement objectives may have been frustrated due to such inordinate delay. The proposed legislation would give the Commission the ability to commence enforcement proceedings rapidly, especially where ongoing conduct places investors or the stability of the system in continuing jeopardy.

In addition to its broader scope, the proposed cease-and-desist remedy would be more effective than administrative proceedings that are currently brought under Section 15(c)(4) of the Exchange Act in at least two respects. First, a violation of a cease-and-desist order would be punishable by a court-imposed civil penalty in addition to a mandatory injunction directing compliance with the order. By contrast, the violation of a Section 15(c)(4) order does not result in any penalty other than a court order directing compliance, the subsequent violation of which may lead to a contempt proceeding. Second, the proposed remedy would expressly permit the Commission to order disgorgement in conjunction with the cease-and-desist order.

B. Proposed Cease-and-Desist Provisions

1. Normal Procedures

The proposed legislation would authorize the Commission to issue cease-and-desist orders to enforce the provisions of the Securities Act, the Exchange Act, the Investment Company Act, and the Investment Advisers Act.[25] The proposal would allow the Commission to issue both permanent and temporary cease-and-desist orders.

A permanent cease-and-desist order would direct the respondent to refrain from future violations, and could also order the respondent to make disgorgement or to take affirmative steps to ensure compliance. Before the Commission could issue a permanent order, the Commission would be required to provide a respondent with notice and opportunity for a hearing. A hearing before an administrative law judge would be set no earlier than thirty days and no later than sixty days after issuance of the notice, unless the respondent consented to an earlier or later date. A respondent would have the right to appeal an adverse decision by an administrative law judge to the full Commission, which would consider the evidence de novo, the same right that respondents currently have in other Commission administrative proceedings. If the Commission affirms on appeal, the entry of a permanent cease-and-desist order could be appealed to a U.S. court of appeals in the same way as any other Commission order. This procedure would be similar to that provided under the Federal Deposit Insurance Act with respect to FDIC cease-and-desist proceedings.[26]

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[25] See proposed legislation at Section 103 (new Section 8A of the Securities Act), Section 203 (new Section 21C of the Exchange Act), Section 301 (new Section 9(f) of the Investment Company Act), and Section 401 (new Section 203(k) of the Investment Advisers Act).

2. Temporary Cease-and-Desist Orders

Where the Commission has determined that a respondent was engaging or about to engage in a violation that is likely to result in dissipation of assets, conversion of property, or significant harm to investors, or that is otherwise likely to result in substantial harm to the public interest before a proceeding could be completed, the proposal would authorize the Commission to issue a temporary cease-and-desist order. A temporary order would require the respondent to refrain from a violation, or to take action to prevent a violation, pending a hearing on a permanent order. A respondent could seek review of a temporary order in federal district court within ten days of service of the order, but the order would be effective and enforceable unless the court or the Commission stayed or suspended it.

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[26] 12 U.S.C. 1818.

3. Enforcement of Cease-and-Desist Orders

The Commission could seek enforcement of both temporary and permanent cease-and-desist orders in district court. In addition to a court order directing compliance, the Commission could also seek, and the court could impose, a civil monetary penalty per violation of up to the greater of $100,000 in the case of an individual ($500,000 in the case of an entity) or the violator's gross pecuniary gain from the violation. [27]

C. Previously Proposed Amendments to Exchange Act Section 15(c)(4)

S. 647 contains provisions that would: (1) authorize the Commission to impose money penalties in administrative proceedings brought under Section 15(c)(4) of the Exchange Act; (2) authorize the Commission to bar persons from serving as officers and directors of reporting companies in Section 15(c)(4) proceedings; and (3) expand the scope of Section 15(c)(4) to include violations of Section 16(a) of the Exchange Act. In light of its recommendation that Congress provide the more comprehensive and flexible cease-and-desist remedy, the Commission no longer believes that amendments to Section 15(c)(4) are necessary.

The prospect of court enforcement and a civil money penalty for violations of a cease-and-desist order should provide adequate deterrence against repeat violations by respondents in the types of financial reporting and accounting cases that the Commission would have brought under the originally proposed revisions to Section 15(c)(4).

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[27] A special provision would require a court to impose a penalty of not less than $100 per day for noncompliance with a cease-and-desist order against further violations of the securities transaction reporting requirements of Section 16(a) of the Exchange Act.

Section 16(a) of the Exchange Act imposes stock ownership reporting requirements on persons owning more than ten percent of any class of an equity security registered pursuant to Section 12 of the Exchange Act, and on officers and directors of an issuer of such securities. The authority to impose administrative fines on individuals who violate Section 16(a) was proposed as a means to enable the Commission to increase the disturbingly low level of compliance with that section. The proposed cease-and-desist authority will provide a remedy to deal with this problem, as the Commission will be able to proceed administratively against delinquent filers. Therefore, the Commission recommends that the proposed fining authority for violations of Section 16(a) be deleted, as the objectives of this provision can be accomplished through the cease-and-desist remedy.[28]

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[28] The Commission is considering a proposed rulemaking that would amend the rules under Section 16(a) in several respects. Exchange Act Release No. 27148 (Aug. 18, 1989). The proposal would require companies to disclose in their proxy statements the names of company insiders who have failed to comply with the reporting requirements of Section 16. Under the proposal, subject to certain exceptions, the Commission also would require an additional report annually from insiders. A purpose of these proposed amendments is to improve compliance and the detection of delinquent filers.

VI. OFFICER AND DIRECTOR BARS

The Commission's revised legislative proposal would expressly authorize the federal courts to bar or suspend an individual who has violated Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act, or the rules or regulations thereunder from serving as an officer or director of any company required to file reports with the Commission.[29] The Commission believes that federal district courts already may order such relief pursuant to their inherent equitable powers, and courts have done so in many Commission cases settled by consent and in at least one litigated case.[30] An express Congressional endorsement would remove any doubts as to the propriety of this remedy. Although the Commission's previous proposal did not limit the use of this remedy to persons who had committed scienter-based fraud violations, the Commission now believes that such a limitation is desirable. The Commission also believes that such orders should be imposed by a court rather than by the Commission. The Commission believes that these changes to S. 647 are appropriate because the Commission would in any event seek this remedy, as it generally has in the past, only in those cases that warrant the bringing of a civil injunctive action and that involve egregious fraudulent conduct.

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[29] See proposed legislation at Section 101 (amending Section 20(b) of the Securities Act) and Section 201 (amending Section 21(d) of the Exchange Act).

[30] See SEC v. Techni-Culture, Inc., [1973-74 Transfer Binder] Fed. Sec. L. Rep. ¶ 94,501 (CCH) (D. Ariz. 1974).

The Commission recognizes that corporate governance issues are generally regulated by state law. The purpose of the corporate bar provisions is not to establish federal standards governing the qualifications of corporate officers or directors. Rather, the purpose of this provision is to protect public investors from persons who have already demonstrated a propensity to abuse a position of corporate trust. Where a person's conduct is such that the disclosure provisions of the federal securities laws, even when supplemented by the coercive power of a federal court injunction, are insufficient to protect investors from further loss, the availability of such a provision is necessary. For example, a corporate officer who perpetrates a financial fraud on the scale of the Equity Funding case, having been brought to justice, should not be permitted to regain a position of corporate control.[31]

VII. AMENDMENTS TO THE CRIMINAL CODE REGARDING GRAND JURY SECRECY

Title V of the proposed legislation would amend the Federal Criminal Code to authorize a court to approve the disclosure of grand jury information to the

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[31] It will be important for Congress to emphasize that specifying this particular type of ancillary relief in the legislation should not be construed as restricting the Commission's ability to obtain other forms of such relief. See J.I. Case Company v. Borak, 377 U.S. 426 (1964) (holding that under the Exchange Act, a court is entitled to provide all relief necessary for the protection of investors). See also SEC v. Materia, 745 F.2d 197 (2d Cir. 1984) (once equity jurisdiction invoked, court has power to order all equitable relief necessary under the circumstances).

Commission for use in enforcing the federal securities laws. [32] It would authorize a court to permit such disclosure upon a showing that the Commission has a "substantial need" for the information.

Rule 6(e) of the Federal Rules of Criminal Procedure permits disclosure of matters occurring before a grand jury when so directed by a court "preliminarily to or in connection with a judicial proceeding." Such an order may be granted only upon a showing of "particularized need" for the information.

A Supreme Court decision regarding rule 6(e) may have the effect of impeding the ability of criminal prosecutors to assist the Commission's civil enforcement efforts. In United States v. Baggot, [33] the Court narrowly defined the purpose for which disclosure may be made. It held that agency proceedings such as civil tax audits are not "preliminary to a judicial proceeding," and thus a court order may not be secured in such cases. If courts were to hold that the Commission's private investigations do not meet the "preliminary to a judicial proceeding" standard, the Commission would be precluded from obtaining grand jury materials no matter how compelling the need. Such a result would be undesirable. The Commission devotes substantial resources to assisting federal criminal authorities in their investigations of securities fraud and related matters. This assistance includes detailing Commission personnel to grand jury investigations. The Commission should not be precluded from obtaining access to information gathered with its assistance. In addition, preventing the Commission from obtaining access to information gathered by Justice Department attorneys would unnecessarily waste federal resources by requiring the Commission to duplicate their investigations.

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[32] See proposed legislation at Section 501(a) (proposed 18 U.S.C. 3323).

[33] 463 U.S. 476 (1983).

The proposed amendment would authorize prosecutors to seek court approval to release grand jury information to the Commission for use in matters within the Commission's jurisdiction. This is intended to eliminate the requirement that court-authorized disclosure be limited to use preliminary to or in connection with a "judicial proceeding." The amendment would also reduce the "particularized need" standard to a "substantial need" standard.

Proposed 18 U.S.C. 3323 in this legislation is modeled on 18 U.S.C. 3322, recently added by Section 964(a) of FIRREA.[34] Section 3322 authorizes "disclosure of matters occurring before a grand jury during an investigation of a banking law violation" (defined to include mail and wire fraud) to identified personnel of a financial institution regulatory agency. Proposed Section 3323 would similarly permit disclosure to Commission personnel of matters occurring before a grand jury during an investigation "of conduct that may constitute a violation of the federal securities laws."

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[34] The Commission believes that the "substantial need" standard explained in the section-by-section analysis of FIRREA should be employed with respect to the provision proposed here. See H.R. Rep. No. 222, 101st Cong., 1st Sess. 446-47 (1989) (conference report).

The Commission recommends that Section 3323 be slightly broader than Section 3322, in order to cover not simply grand jury investigations of securities law violations, but also investigations of other kinds of conduct (such as mail or wire fraud) that may constitute securities fraud. This is important because grand juries that investigate conduct covered by the federal securities laws often return indictments charging only violations of more general federal criminal statutes.

VIII. CONCLUSION

Effective investor protection requires that the Commission have flexible and effective tools to deter violations and to move promptly against securities law violators. S. 647, with the Commission's proposed changes, would provide the Commission with these tools. The Commission urges prompt consideration and enactment of this proposal. Our objective is to protect the integrity and stability of the nation's securities markets and the vital ability to raise equity capital by preventing fraud, manipulation and other violations of the securities laws that may harm investors, create serious risks of loss or systemic problems, or otherwise undercut the confidence that is critical to a healthy capital market. At the same time, we remain sensitive to the need to ensure fair treatment for regulated persons and institutions, as well as others subject to the Commission's jurisdiction, in the overall application of the enforcement program.

2/1/90

EXECUTIVE SUMMARY OF THE STATEMENT OF RICHARD C. BREEDEN, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, BEFORE THE SENATE SUBCOMMITTEE ON SECURITIES, CONCERNING S. 647

S. 647, the "Securities Law Enforcement Remedies Act of 1989," is based upon a legislative proposal originally submitted by the Commission to Congress in January 1989. After a careful review of the bill and the troublesome areas the Commission faces in its enforcement program, the Commission has concluded that the original legislation should be enhanced. Accordingly, the Commission recommends new language today for the Subcommittee's consideration. As modified, the legislation would give the Commission increased adaptability and strength in enforcing the securities laws to protect investors from illegal activity such as financial and accounting fraud, penny stock fraud, market manipulation, and fraud in the offer and sale of securities.

This proposed legislation would amend the federal securities laws to:

- authorize the federal courts to order the payment of civil money penalties, in addition to disgorgement, for violations of the federal securities laws;
- authorize the Commission to order disgorgement and impose civil penalties in certain administrative proceedings;
- authorize the Commission to issue cease-and-desist orders for violations of the securities laws; and
- expressly affirm the inherent authority of the federal district courts, in connection with injunctive actions brought by the Commission, to issue orders that prohibit individuals who have committed egregious violations of Section 17(a)(1) of the Securities Act of 1933 or Section 10(b) of the Exchange Act from serving as officers or directors of any reporting company.

In addition, the proposal would amend the Federal Criminal Code to authorize a court to issue an order permitting disclosure to the Commission of grand jury information concerning potential securities law violations for use in matters within the Commission's jurisdiction.

The Commission's revised proposal differs from S. 647 as introduced in five respects. First, unlike S. 647, the revised proposal would expressly authorize the Commission to issue cease-and-desist orders for violations of the federal securities laws. Second, the revised proposal would expressly authorize the Commission to order disgorgement of illegal profits in its administrative proceedings against regulated entities and in its cease-and-desist proceedings. Third, the revised proposal would provide that the express authority of the federal courts to bar securities law violators from serving as officers or directors of reporting companies be limited to cases involving violations of certain scienter-based fraud provisions. Fourth, because the revised proposal contains cease-and-desist authority, it would not contain the amendments to Section 15(c)(4) of the Exchange Act found in S. 647. These provisions of S. 647 would provide for civil money penalties and officer-and-director bars in Section 15(c)(4) proceedings and would expand the bases for these proceedings to include violations of Section 16(a) of the Exchange Act. Fifth, the revised proposal's provision relating to grand jury information is not in S. 647.

CIVIL MONEY PENALTIES

Virtually every federal regulatory agency, including the Commodity Futures Trading Commission and the federal bank regulatory authorities, has the statutory authority to seek or impose civil money penalties. Indeed, Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA") six months ago, authorizing increased penalties of as high as $1 million per day for certain banking law violations.
The Commission, however, has only limited authority to seek civil money penalties. Most significantly, the Commission may seek a civil penalty for insider trading violations.

The Commission believes that the money penalties proposed in this legislation are needed to provide financial disincentives to securities law violations other than insider trading, many of which may be enormously lucrative to the violator. In addition, a money penalty would provide a flexible remedy for the many cases where the Commission is faced with choosing between a remedy that is too weak, such as a censure, and one that is too harsh, such as revoking a violator's registration. By authorizing money penalties for other violations of the securities laws, the proposed legislation would greatly increase deterrence, while also providing both the Commission and the courts with the flexibility to tailor a remedy to the gravity of a violation.

CIVIL PENALTIES AND DISGORGEMENT IN ADMINISTRATIVE PROCEEDINGS

The legislation would permit the Commission to assess civil money penalties and to order disgorgement of illegal profits in certain administrative proceedings. The penalty amounts would range up to $100,000 per violation committed by a natural person, and up to $500,00 per violation committed by any other person.

CIVIL MONEY PENALTIES IN JUDICIAL PROCEEDINGS

The legislation would authorize the federal district courts to impose civil money penalties, in addition to disgorgement, for securities law violations. The maximum penalty which a court could impose for each violation would be the greater of (1) $100,000 for a natural person or $500,000 for any other person, or (2) the gross amount of pecuniary gain to the defendant as a result of the violation.

CEASE-AND-DESIST AUTHORITY

Many other federal agencies are already empowered to issue cease-and-desist orders. The legislation would authorize the Commission to issue both temporary and permanent cease-and-desist orders. This kind of remedy would permit the Commission to address specific violations more quickly and efficiently through a streamlined administrative procedure. A cease-and-desist order is a flexible remedy that could be used instead of an injunction to address different violations that are more appropriately resolved in an administrative forum.

COURT-ORDERED OFFICER AND DIRECTOR BARS

The legislation would expressly affirm the inherent authority of the federal district courts to bar or suspend an individual who has violated certain anti-fraud provisions of the Securities Act or the Exchange Act from serving as an officer or director of a reporting company. The Commission believes that the federal district courts already may order such relief pursuant to their inherent equitable powers, and courts have done so in many Commission cases settled by consent and in at least one litigated case.

AMENDMENTS TO THE CRIMINAL CODE REGARDING GRAND JURY SECRECY

The legislation would authorize a court to permit disclosure of grand jury information to the Commission for use in enforcing the federal securities laws upon a showing that the Commission has a "substantial need" for the information. Matters subject to disclosure would be those occurring before a grand jury during an investigation of conduct that may constitute a violation of the federal securities laws. This proposal is modeled on Section 3322 of the Federal Criminal Code, recently added by FIRREA.

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The Commission urges prompt consideration and enactment of this legislation.

Senator **Dodd**. Thank you very much, Mr. Chairman.

At the outset, let me suggest that we allow 7 minutes or so per member to help move the process along.

With respect to the cease and desist authority, we do not have any specific language from you yet. How soon can you have that language for us?

Mr. **Breeden**. We are working very hard on the whole legislative proposal, and we will certainly have that to the committee not later than next week.

I would add in the cease and desist area, the language we are proposing parallels very directly and very closely the cease and desist procedures that are applicable in the Federal Deposit Insurance Act and existing law.

Senator **Dodd**. You anticipated my next question.

So if we examine that legislation here, we will be basically on-track?

Mr. **Breeden**. Yes.

Senator **Dodd**. You and I, as I mentioned earlier, had a very worthwhile conversation yesterday. Some of the questions I raised with you yesterday I noted I would raise with you today as well in the public hearing. Some have suggested, as I brought up with you yesterday, that this cease and desist order is going to place a tremendous amount of discretion in an administrative agency.

I know other agencies have this authority; but here, you are dealing with such an important element of our economy. This could, some have said, have a chilling effect—in encouraging capital investment, encouraging risk taking—if we create cease and desist orders which place tremendous power in the hands of the Commission.

How do you respond to that? While other agencies have it, all agencies are not alike. They have entirely different functions to perform. This one, should be not just treated as any other agency. Therefore, cease and desist powers ought to be handled very cautiously.

Mr. **Breeden**. Senator, I think I would agree that agencies are different, and that it is not a sufficient justification to simply say, "Well, other agencies have this remedy; therefore, we ought to have it also."

We should provide more analysis than that. And I would hope that the Commission's full testimony will provide that justification.

I was attempting to suggest in initially pointing to the other agencies that this is not an unusual suggestion, this is not an unusual remedy. This may be something new to this particular area of securities law. It is perfectly standard, normal operating procedure for administrative agencies throughout the financial regulatory world, as well as throughout the rest of the Government. So we do not see it as something that should be seen as some type of extraordinary, threatening remedy.

To the private world, and those interested in participating in our capital markets, indeed I would suggest that its availability to the Commission might give comfort and encouragement to both investors and those participating in the markets, in that they will have greater assurance that where we are aware of individuals or organizations that may be violating the law, we have the best possible ability to bring those violations to a halt quickly.

We of course today have an ability to go to the Federal district court and seek a temporary restraining order, seek an injunction, and move very quickly. Sometimes, we do have to move with lightning speed.

I would point to several recent cases in which we were successful in obtaining court orders, freezing assets that represented in our view the illicit profits from insider trading before those funds could be transferred outside the country and beyond the reach of the Federal courts. We were successfully literally in stopping the payment process before those funds could be moved off-shore.

So we do have an ability today to move quickly. And in the most serious cases, we can get in front of a Federal court quickly to get that type of relief. There are other cases that are important to us, but where it may be more difficult to get a Federal district court to put aside their drug cases and their criminal cases and the full spectrum of their docket, to take up something where we would like immediate relief.

We are trying to go in and get all those cases put aside, so that we can get the court to take up an ongoing violation of the cold calling rule. That is something we might or might not be successful in doing, but if we have the cease and desist proceeding, we can step in and tell the brokerage firm, "You have got to stop that procedure, and stop it today," and thereby bring some immediate protection to investors who may be continuing to be victimized by that ongoing violation.

So I see it as something that we can apply in a very balanced and measured way. It is something that is traditional in the law, and I think on the whole should provide a stronger market and stronger incentives to participate in our market, rather than disincentives.

Senator DODD. You said this, but I think it deserves repeating. What you are talking about here is an order to be issued by the Commission. This is not a power to be extended to regional offices; in fact, it would take a vote by the Commission. It is not just the chairman, either. Is that correct?

Mr. BREEDEN. That is correct. In fact, there is quite an extensive protection in the administrative hearing process. The full Commission has to vote to bring the case. It then is heard by an administrative law judge. In the case of a normal C&D, as opposed to a temporary order, we go through a full hearing before an ALJ, in which the respondent has notice of the charges, has the full right to participate, has an opportunity to take an appeal to the Commission of whatever decision the ALJ reaches and, if he remains dissatisfied with the final action by the Commission, then has the ability to go to a Federal court of appeals to seek to overrule the Commission.

So there is a full process of protection in this procedurally.

Senator DODD. Let me move to the civil fine area. And I am sure my colleagues will have some additional questions on this cease and desist question, as I may a little later.

One of our witnesses who will appear in the second panel, Mr. Futter, has suggested that the civil fine authority is overly broad.

You may have had a chance to review his testimony. He cites, for example, that the $100,000 fine per offense for an individual could be a pretty hefty fine of someone who is charged with a few days late filing of stock ownership reports, for instance.

In your testimony, you suggest the possibility of tiering these offenses, so you would avoid, as I read it anyway, the very legitimate concern raised by Mr. Futter.

I am impressed with the tiering concept in response to the broadness of the fine approach. But the question one immediately confronts is that it sounds like you are complicating things. It sounds good to read it, but how do you do it and not make the job of the SEC that much more complicated and that much more difficult?

Is it really being done in a sense to respond to the opposition? Or, is it in truth a proposal that would deal effectively with the question of civil fines?

Mr. **Breeden**. We originally proposed the fines without any concept of tiering. We would be perfectly comfortable with Congress passing these provisions with the maximum penalties available, and leaving it to the discretion of the Commission and the courts to tailor the particular fine to a particular offense.

Obviously, if someone is 2 days late in filing a focus report, that is a very different type of violation and would warrant a different penalty than someone who is engaged in a conscious and deliberate attempt to defraud investors of millions of dollars, as we encounter in some of the penny stock cases.

We are comfortable that the courts have in the past shown the ability to pick an appropriate level of fine, just as the Commission does in structuring its penalties. Where we have discretion, we may seek three times the amount of the insider trading profits, but we do not do that in every case. We do in fact tailor the amount we seek and the amount that we end up settling for.

So we would be comfortable with just setting a maximum without tiers. However, recognizing that Congress considered this and the same question was raised when we were looking for the $1 million a day penalties for those individuals who defrauded the savings and loan and ended up costing the taxpayers hundreds of millions of dollars, or billions of dollars in a particular case—we wanted a very severe sanction to be available.

Yet you would also have violations in which somebody was 2 days late filing a cause report. So in that case, as you know, Congress set out three categories. And the Commission's testimony was intended to suggest that if, when you finish hearing from the commentators, it is your judgment that the tiering approach would be desirable, then the Commission is perfectly willing to work with this committee in developing the appropriate tiers.

It will add complications. It is not as easy to accomplish as it is to state. But we are willing to work with you in that area. We think it is important that we get the fining authority. We will take it in one lump, or in tiers, but it is really important that we have that remedy.

Senator **Dodd**. Senator Heinz.

Senator **Heinz**. Mr. Chairman, I cannot resist observing that some people are going to get their lumps one way or another.

Before I turn to my questions of Richard Breeden, I noted on the witness list the inclusion, appropriately, of Aulana Peters, former Commissioner of the SEC, now in private practice in Los Angeles.

I am advised that she will have to leave at approximately 10:45, in 15 minutes, to catch a plane. I just wanted to acknowledge on behalf of the committee that she was a consistent voice for strong and vigorous enforcement at the SEC of the securities laws during her tenure there. I just wanted to make that recognition on the record. I am sure others will want to join in that.

Is my information on her departure correct?

Senator DODD. If my colleague would yield, if that is the case, we can proceed however my colleague might like to proceed. If you want to allow Ms. Peters to come and make a statement or testimony, or to go ahead with your line of questioning and then have her do it, we can proceed either way.

Senator HEINZ. It is the chairman's call.

Senator DODD. Is Senator Heinz correct in that, Ms. Peters? Are you faced with that?

Ms. PETERS. Yes, I am. But this is an important hearing, and I decided to try and wait it out, and perhaps take a different flight. But of course, I would accommodate the Senators' desires, and perhaps proceed with Mr. Breeden, and then perhaps I can make a statement after Senator Heinz finishes his questioning.

Senator DODD. Fine.

Senator HEINZ. Mr. Chairman, thank you. That is very generous of you.

There really are two types of questions I would like to pursue with you, Richard. The first has to do with your priorities, and the second, some of the kinds of questions Senator Dodd was asking you about the SEC's enforcement authority.

Priorities are important because there are always trade-offs involved. There clearly has been a major emphasis on certain kinds of high-profile cases such as insider trading. Stock parking has also been highlighted by the work of the Commission in these years. You recently indicated, that the SEC is going to also place emphasis on small investor enforcement issues and financial fraud.

I would like to know more about those priorities, as well as what kind of effort is going to be made on illegal or questionable market trading practices, such as frontrunning, or legging, or short sale violations?

My general question to you is, as we enter the 1990's, what are the trade-offs, what are the challenges, what are the priorities of enforcement? What are the trade-offs going to be? Are you going to have to pursue fewer international enforcement cases, in order to bring more penny stock fraud causes?

Mr. BREEDEN. Well, there is no question that in running any governmental program, we always have to try to set prioritizes. In this area, as with all areas of financial regulation, that is not an easy task. Every one of our statutory provisions that we are charged with enforcing, and every one of our regulatory programs, has an important purpose.

If we focus all of our activities on policing a particular area extremely well, and have no presence in another area, then the level of compliance which is most likely——

Senator HEINZ. The reason I ask is really tied to the authorities that you want, and which in general we want to give you. If you can indicate where the SEC is going to have to do more, we will have a sense of what you need in the way of additional tools. That is really the import of my question.

Mr. BREEDEN. Well, I think we are very concerned about doing more in a number of areas, including policing financial reporting and financial statement fraud, policing the integrity of the offering process and reporting process, so that people can rely on financial statements that they may in fact be basing investment decisions on.

We are very concerned about improving the integrity of the adherence to the law among financial institutions, because we think that the financial system ought to be the base of the strongest possible solvency, and that people ought to have the utmost confidence.

Senator HEINZ. When you say "financial institutions," in what particular ways are you concerned about this? Is this reporting? Is this capital requirements? What are you talking about?

Mr. BREEDEN. I am talking about compliance with both the 1933 and 1934 Acts by financial institutions in the financial statements that they issue of their own financial condition, in the practices they might use, in the distribution of securities to investors—any number of areas of that kind.

Obviously this is not to replace the application by a bank or thrift regulator of the normal rules and requirements for the operation of that institution but rather to look at their participation in the capital markets.

I am very concerned about bringing a higher level of attention to issues that directly impact individual investors. The penny stock area is certainly a most vivid one. Thousands of individuals may get defrauded, in some cases of their life savings. Not only those individuals, but their friends and their relatives, and people who go to their churches or know them in any capacity in the community, may be deterred from ever participating in the securities markets because of the fear of being victimized in that area.

Senator HEINZ. Mr. Chairman, that is very helpful, and I thank you.

I would like to at this point just follow up some of Senator Dodd's questions on your civil monetary penalties request. Let me say that I think the SEC, in coming here today and making some modifications, has answered some of the concerns of certain critics of the legislation. But I would like to raise at least two, if I can, in the time remaining.

There is a criticism that the requirement that the legislation does not contain a requirement that misconduct giving rise to a bar against a director or an officer bear upon the person's fitness to serve as an officer or a director. Would you care to answer that criticism?

Mr. BREEDEN. I think two of the modifications we have made in that area should address some of the complaints and concerns that have been raised. One is to limit the sections that can serve as a predicate for an officer and director bar to section 17(a)(1) and section 10(b). That alone will eliminate the complaints which I think existed in people's minds. I do not believe the Commission generally brought such proceedings for violation of other statutory sections that did not involve deliberate, knowing fraud violations.

We hope this change will tie that sanction to activities that are much more deliberate by the corporate officers involved.

Senator HEINZ. You would say that these parameters address the issue of fitness to serve. How do you respond to the criticism that this is an invasion of State corporate governance requirements?

Mr. BREEDEN. We disagree with that. State corporate governance is important, but this provision gets at the fact that certain individuals may be repeat and egregious violators of the Federal securities laws, and may in the future seek to become associated with public reporting companies under the Federal securities laws. This is a remedy which the courts have applied in the past, as ancillary to their equitable jurisdiction.

We want to clarify that the courts can and should have this remedy available to them. And we have dropped the request for the ability to impose this power administratively, which I might add many people think we already have. But we are prepared to leave it to the courts to decide those circumstances where an individual—such as, for example, Robert Vesco, who may have been convicted of the most serious types of violations of the securities laws—should not be able to come back in the future and seek to become a director, exercising fiduciary responsibility over a public company.

In extraordinary cases, there are certain individuals to whom we should simply be able to say, "Your conduct has been so severe that you are not going to get another opportunity to do it again."

Senator HEINZ. Just a brief follow-up. I know I am over my time.

The rationale for our securities laws has been disclosure. The theory is that shareholders and investors, owners, armed with all the facts, will make well informed investment as well as corporate governance decisions. Under current law, an officer or director who violates Federal securities laws must disclose those violations to shareholders. Shareholders can choose to vote that violator out of office, or refuse to put him or her in office in the first place.

The question that has been raised is, notwithstanding the fact that what you say makes sense, why can't the shareholders make those judgments? Is there something wrong with the system that we have? Is disclosure not enough?

It seems to me, you have to make the case that the theory on which we have been proceeding all these years is inadequate to realities today.

Mr. BREEDEN. Of course, disclosure, as you know, Senator, is a feature of the offering of securities. And that philosophy is really built around the decision of investors as to the investment merits of the security.

Senator HEINZ. It is also required for annual elections of directors.

Mr. BREEDEN. Yes. And throughout the reporting system, disclosure is certainly an important element. But I would analogize it to the following situation. We do have quite, commonly, statutes in this country that prohibit convicted felons, for example, from being able to hold public office in the future.

Senator **Heinz**. This is true.

Mr. **Breeden**. Notwithstanding the fact that you can make the same argument: The population should have the opportunity to vote for this individual, notwithstanding their conviction.

Senator **Heinz**. Of course, Mayor Curley did serve, I believe, with distinction, while incarcerated in Boston.

Senator **Dodd**. Some would say that is the only place you can serve. [Laughter.]

Senator **Heinz**. Well, I want to follow this up, but my time has expired.

Thank you very much.

Senator **Dodd**. I have been told that Ms. Peters has an opportunity to catch a little later flight, so we thank you for that, Ms. Peters, and will turn to Senator Riegle.

Senator **Riegle**. Thank you, Senator Dodd.

I want to ask two questions with respect to the proposed legislation, itself. The bill would allow the SEC to impose civil money penalties in administrative proceedings. Some concerns have been raised that the SEC might not be able to be impartial in deciding whether such penalties are appropriate, because the SEC gets indirect credit for the amount of the fines imposed.

I am just wondering, what steps would the SEC have in mind to assure that, with this authority, there would not be an abuse along that line?

Mr. **Breeden**. Senator, the fines that might be imposed would go to the Treasury. I do not know of the indirect credit that you are referring to. We have, regrettably, run an enormous surplus for the Treasury every year, and that surplus is just part of the general fund of the Treasury. So I do not believe we would get any money of any kind.

Senator **Riegle**. So you would just discount the notion that there would be any tendency to have that be a factor?

Mr. **Breeden**. Yes, sir, I do. Here again, these cases have to be approved by the full Commission itself before they can be brought. I cannot see the Commission approving a case based on any consideration of a fine.

The same issue of course could be raised in connection with the current, very large fines that are available under ITSA, for insider trading. Congress decided 5 years ago to give us the authority to obtain fines in those areas. I think we found over the past 5 years—and I have just looked over a number of cases in which we were seeking an ITSA penalty—that it's an important and helpful deterrent to that type of conduct.

I would not share the concern that you mentioned.

Senator **Riegle**. The SEC has stated that it would only seek to bar or suspend persons from serving as officers or directors in cases involving repeat violations of the securities laws, or in instances of egregious conduct. The bill, as currently drafted, has no such limitation. I am wondering if you think we should include such language.

Mr. **Breeden**. This is a remedy that we would not expect to see imposed frequently. Happily, the kind of egregious and repetitive, serious violations of securities laws that would justify that type of penalty do not occur every day.

We would not have an objection, certainly, if the report language and the deliberations of the committee indicated that this is designed as a remedy for those most serious cases.

If we start putting limitations in the statute itself beyond tying it to the specifics of the violations, as we have now done in our revisions, I think it could make it more difficult to use the remedy in those cases where we would need it.

Senator **Riegle**. Let me move to a different topic, and that relates to junk bonds.

On October 5, as you know, I sent you a letter asking about recent events in the junk bond market and circumstances in which they have been used. I did not get a formal response. I know one is in the mill. We would like to get it, obviously, but while you are here, let me ask you some specific questions that were contained in that letter.

To date, does the SEC know what kinds of institutions hold junk bonds, and in what amounts?

Mr. **Breeden**. Well, I think certainly we are aware, as is generally publicly known, of the distribution and holdings of junk bonds by major categories of institutions, insurance companies, and others. I do not claim to know the location of every junk bond, so I guess it would depend upon the level of detail.

Senator **Riegle**. Do you think you have a pretty good sense as to where the junk bonds have accumulated, in terms of industry sectors? How many, for example, are in the insurance industry, underlying presumably present and future claims by policy holders? Would you have that?

Mr. **Breeden**. I would be more comfortable with responding to you in the letter. We are working very hard on it, Senator. We do regard this as an important issue. We have some general statistics on holdings among insurance companies. I just would not want to answer with any specificity now.

Senator **Riegle**. I am concerned that we may not know very much about it. That is why I sent the letter. I am very much interested in a response.

What about current market information about junk bonds? Would it make any sense to think in terms of trying to develop a market where small investors could get market information on a real time basis? Is that practical with junk bonds? Is it desirable?

Mr. **Breeden**. Of course, real time information as to prices and spreads is I think always desirable. In the market, lack of information tends to produce wider spreads, and the professionals may make more money at the expense of investors. So I think we would generally favor wider distribution of information.

Senator **Riegle**. Do we need a mechanism we do not have? Is there sufficient market mechanism out there, in your view?

Mr. **Breeden**. There is a lot of concern as to the lack of availability of reliable quotations for a number of these securities. Some are widely traded, and there are pretty accurate price indications. Others are much less frequently traded, the market is much thinner, and there may not be such good indications.

It is of course not necessarily a simple job to remedy that, since, as you know, if you have very thin trading in a particular security then you can have a very elaborate reporting mechanism, but what you are reporting may not be based on a very reliable sample of data.

So I think we have to be very cautious in that area. But these are among the questions we are trying to look at very carefully, in, I should add, fair detail, in response to your inquiry.

Senator **Riegle**. Do we understand this market well enough to know the impact of a single issue of junk bonds? A single company, suddenly having adverse news about it? I am concerned about reports of a decline in the junk bond market, as a whole, beginning last year. Even more frequently and more recently than that, but in one instance triggered by Campeau's financial problems. It seems to have kicked off a major decline in the market, generally. And then more recently, just in the last few days, the RJR Reynolds bonds seem to be leading a general negative condition in the market as a whole.

Is it the nature of that market, maybe uniquely, that one issue could have such a dramatic effect?

Mr. **Breeden**. That is a factor, I suppose, in a number of markets. I recall back when the Penn Central bankruptcy filing threw the commercial paper market into a rather considerable tail-spin, and other cases in which the commercial paper market was significantly affected by the failure of a very large issuer, and the fears that that might create in the market.

The same could be true in the corporate debt market. Certainly, even the Government debt securities market is often affected by rumors involved in a variety of factors, including the health of a variety of presidents these days. So all the markets can be affected by either a very significant economic event, such as a major insolvency of a major issuer, or factors that may be perceived as altering the risk calculation for all of a particular type of security.

And I suppose junk bonds are not immune to those processes.

Senator **Riegle**. I think this market, though, is showing characteristics of being more fragile, more susceptible to being knocked askew by maybe a single story. I think it gets into this question of, what is this market?

It goes back to my earlier questions. I am not sure we know very much about it. I do not think we know as much as we need to know. And just as a final comment—because my time is up, now—but I think increasingly there is a question as to who is exercising control in today's very highly leveraged corporations, whether the bond holders de facto are becoming more the driving force, versus the shareholders. I think it raises some very significant questions with respect to our whole concept of the SEC and other companies, and responsibility.

I am very much interested in getting a response that we have sought on these issues, and then pursuing it.

Thank you, Mr. Chairman.

Mr. **Breeden**. Senator, I would just agree with and concur in your judgment. It certainly does raise some very serious and significant, far-reaching issues.

One of the reasons for the delay, for which I do apologize is that we have been working very hard on this, and because some of these issues are so difficult we want to do a first-class job in responding to your inquiry. But I agree, it raises some issues that are well worth considering for their long-run implications.

Senator **Riegle**. Thank you.

Senator **Dodd**. Thank you, Mr. Chairman.

Let me ask you a couple of quick questions, if I can here, and move you along this.

You referred obviously in your written testimony as well as in your oral testimony this morning, to the areas that concern violations of section 16(a), the stock ownership reports by officers. I presume you know that Congressman Ron Wyden has introduced legislation in the House to deal with this time period issue.

He raises concerns—and apparently you have expressed concern about the growing abuses in this area—about the fact that you file reports ten days after the first of the month. You have the obvious situation of a transaction occurring on the 1st or 2nd of the previous month, being reported after a 40-day period, which makes it far more difficult to get information about insider trading.

He has proposed legislation to shorten that period. I wonder if you just might comment on Congressman Wyden's approach, and whether or not you think legislation is necessary.

Mr. **Breeden**. First of all, section 16(a) is an area in which there is a disturbing level of noncompliance. Around 37 percent of the reports that are required are filed late, oftentimes very seriously late. And we are not happy with that.

I recently met—as did the entire Commission—with a group of corporate secretaries, to make sure that they were aware of our very high level of concern about this area. This legislation that we have before the subcommittee today would enable us to levy fines on individuals who did not take seriously their reporting obligations under 16(a), so we are responding in the legislative forum with this very legislation.

As to Congressman Wyden's bill, we have talked to the Congressman about this subject, and share his concern for the importance of some of these reports. Investors do follow this information. If the CFO is buying or selling very heavily in the company, that is information that investors find frequently quite relevant. So we want to make sure that information gets out into the marketplace.

The difficulty is that there are an awful lot of individual reports in this area, about 130,000 reports a year. Under the Congressman's legislation, at least as it is now framed, we would see about a 30 percent increase in the number of reports that would have to be filed. So we are talking about tens of thousands of additional pieces of paper that we would have to process.

The number of large and significant transactions by top insiders is of course a very tiny sub-set. Many of these reports are generated by transactions out of employee benefit plans and other events that do not represent something that an investor would really want to key his or her actions off of.

We would like to continue to work with this area, to see whether we can get the noncompliance down. And we are looking with him at ways in which we can perhaps restructure the area, so that the few very significant cases have a quicker reporting requirement, but not the tens of thousands of largely insignificant reports.

Senator **Dodd**. We will be anxious to deal with that, of course, in this proposal.

You and Mr. McLucas have suggested that there needs to be renewed efforts to protect the small investor. I wonder if you might suggest what those efforts would be?

We have always thought of the SEC as having as one of its functions to protect the small investor. What needs to be done that has not been done in terms of this mission?

Mr. **Breeden**. Senator, I participated in a proceeding the other day in which we were looking at a range of enforcement actions against a number of individuals in a penny stock case that involved literally thousands of participants and thousands and thousands of investors who had lost several millions of dollars.

I think the Commission has worked long and hard to protect individual investors. That is the bedrock core of our mission as an agency. But I am not going to say we have been perfect. There is a lot of room for improvement in a number of areas.

I would particularly mention the penny stock problem. There are also other areas where, frankly, we want to be sure we attack the potential abuses that may be occurring because we think that some of the volatility and the perception of the existence of manipulation in the market will deter individuals from being willing to participate.

Senator **Dodd**. I know Senator Bryan has a deep interest in that, and he wanted to proceed on legislation and with hearings. I hope he will follow up on that, and I am confident he will. It is really an area that deserves some attention.

I will bring up a subject you raised yesterday, and then turn to Senator Heinz and go on to our second panel, and submit additional questions to you in writing. That question relates to the whole problem of jurisdiction, and the multiplicity of regulators—what one of our witnesses on the next panel, Judge Sporkin, has called the "balkanization" of the regulatory process.

While we take great pride in talking about the supermarket we offer in terms of financial services, some have suggested that you have got a supermarket of regulatory agencies, as well. I thought you made some very good points yesterday, when we chatted privately, about that problem as we go into the global arena.

You described how you show up at meetings, there are other countries there, and then there are the two or three agencies of the United States. Not only does it confuse people here, it confuses people all over the world, as to who you look to: the SEC, the CFTC, the Justice Department, the various State regulatory agencies.

I wonder if you just might talk for a moment or two about that particular problem, as we move into a global marketplace, and the legitimate concerns raised by investors and people involved in the securities industry that this is a growing problem.

Some would see it as an advantage, I suppose. Maybe if there are that many regulatory bodies out there, the situation is confused enough that it may make it easier to engage in fraudulent activities. But certainly, I see it as a problem, a growing problem.

You expressed to me your concern about this, and I wonder if you might share your general comments.

Mr. **Breeden**. Senator, I do regard this as a very important concern, a very important problem. We have to look at not just modernizing some of our substantive laws, the banking and securities laws, but also look at the overall process by which we enforce the law.

Traditionally, we have taken great comfort from not having the regulatory power of government centralized to too great a degree. Thus, we have had a number of different agencies. Even in an industry like banking where there are three different agencies, we always thought that division created certain benefits, as did the division between the Federal Government and the States.

Division and decentralization also create some costs. They are very real costs. It makes it in many cases more difficult to enforce the law, where you have regulatory fragmentation in what is a single market. For example, one of the problems I am very concerned about is trying to deal with the potential for manipulation, not of a single stock, but intermarket manipulation between the futures market and the stock market.

Unfortunately, in looking at transactions to determine whether they are normal, legitimate transactions, or whether they are part of the deliberate attempt to manipulate the market, there are two sides to the transactions. And one is occurring under one agency's jurisdiction, and the other is occurring under our jurisdiction.

It makes it much more difficult to look at what is in reality a single transaction in a single marketplace when you have to coordinate the enforcement efforts of two different agencies. It does I think have an impact on enforcement. There is no question that it has an impact on competition.

One of the things I hope to work on with this committee and the Congress in the next few months is the extraordinarily serious problem we have with the interpretation of the exclusivity clause of the Commodity Exchange Act, which is now operating to cause the export of jobs and products out of the United States to foreign markets, because we cannot get American products into the marketplace.

We have to spend 3 and 4 years testing them. The other international markets do not have some of these restrictions. We are the only country in the world that has a separate agency for the cash market and the securities market. Every other major securities market in the world, including those with very active futures markets, has a single agency that regulates both the stock and the futures market.

Because we have that division, and if we have to litigate about whether every aspect of every product should be on one side of the fence or the other, there will be costs to United States firms that are not borne by their United Kingdom, or Japanese, or other competitors.

So there are terribly serious issues, these differences of basic regulatory structure, like leverage, the margin requirements, and so on. We have a difficult job. I do not have a simple, neat answer for you in terms of what ought to be done, but I would like to see us recognize the greater competition we face internationally by doing everything we can to create greater efficiency here at home.

And there is quite a bit I think that can be done to streamline the governmental structure.

Senator Dodd. I raised this here, because I found your comments yesterday so interesting in my office. Obviously, we have got a specific bill we are talking about here today, but I did not want to miss the opportunity to hear you briefly and articulately describe what you did to me yesterday.

Being fully aware of the hornet's nest one can hit here, let me suggest to you, at least speaking personally as chairman of the subcommittee, that I would very much like to see us debate this issue in this Congress. I realize it is one that will immediately raise some feathers in certain quarters, but it needs to be addressed.

This is just ridiculous, in my opinion. We are proceeding down a path that is going to create such a disadvantage in my view, to U.S. competitiveness. We will have to work that out up here first, I suppose. But I would like to proceed and hold hearings and discuss that very question at another time when we can go into a little more depth. I appreciate very much your response this morning.

Senator Heinz.

Senator Heinz. Mr. Chairman, on that very point, I agree with you on the significance of this issue. I take it from your last comment, that you intend to hold hearings on this issue.

I am not trying to put words in your mouth, but I thought that was what you said.

Senator Dodd. I would very much like to. I suspect I am going to hear from a couple of my colleagues before the day is out on this. [Laughter.]

Senator Heinz. If it is any help, Mr. Chairman, should you wish my support, you certainly have it.

Senator Dodd. Thank you. That is two of us.

Senator Heinz. You are right about the hornet's nest. But it is still a critical issue. We should not be deterred from examining even the most fearful subject, politically fearful in this case. If you have got a time bomb ticking, you can ignore it and let it go off, in which case you may go up with it; or you can try a more immediately dangerous course, finding out what makes it tick, and trying to defuse it so that nobody gets hurt.

I spent a fair amount of time looking into the issue of the exclusivity clause, and it is a complicated issue, but it is one that nobody is going to benefit from if we allow the present practice, which does force many transactions which should be done in the United States to go overseas.

You cannot do swap transactions in an open outcry market. People who think that they can do them are wrong. That kind of market, which is required of course, for commodity futures transactions, simply does not function well when applied to swaps.

These are the kinds of issues we need to hear more about. They are enormously complex. They have far-reaching effects. I hope the Chairman will in fact brave the wasps, hornets, and spiders that are likely—and probably, a few snakes as well—that are likely to crawl out of the woodwork, if he and I put our fingers into this particular nest.

But I think we should. And as I say, I support him in that effort.

Senator **Dodd**. I appreciate that. We will raise it with Chairman Riegle and others. Subcommittee chairmen ought to be somewhat hesitant before announcing the schedule. [Laughter.]

Senator **Heinz**. Mr. Chairman, I am all for you.

Mr. **Breeden**. Could I just make a real quick comment?

Senator **Heinz**. Only if it does not cost me time. [Laughter.]

Mr. **Breeden**. I would just say that, while it is a controversial area, and I want to emphasize that, we share the concern of many that the U.S. futures markets should be competitive internationally. We do not want to see anything done that would do competitive damage to the strength of that aspect of our market.

You focused on one part of it. It is really a double problem. One is, that the regulatory division is today, as we sit here, having an effect on the competitiveness of the U.S. securities markets and U.S. securities firms. Additionally, it raises some aspects of this jurisdictional division. It raises most serious issues going to the stability of the marketplace.

We know that there are millions of investors who are concerned about the volatility levels in the market, who are concerned about maintaining a stable marketplace. And while we have seen in the past areas in which regulatory structure and the nature of regulatory programs were controversial, yet we also have got evidence that it can end up costing the public hundreds of billions of dollars.

So I would commend you, and we would certainly express a willingness on our part to try, in a cautious and deliberate way, to address these issues because they are most serious.

Senator **Heinz**. Mr. Chairman, I would like to return with Mr. Breeden to the question of barring officers and directors. By the way, if the issue is, should somebody who is convicted of a felony be barred, I think that is an open-and-shut case. Let's put that one aside, and focus on the question of disbarment for civil violations.

It seems to me that you have to make the case—I have not heard it made, yet; that does not mean it cannot be made—that disclosure is inadequate for some reason. It could be that the people simply do not read the front of their proxy, which in large red letters says, "Joe Schmo, who is up for a directorship has been found by a court to have committed securities fraud—if those are the right legal terms. Or, you would have to make the case that some structural impediment now exists that renders disclosure today an inadequate procedure.

It seems to me, one or the other, or both of those cases should be made. Maybe there is a third kind of justification, but so far I have not heard any of those.

Mr. **Breeden**. Senator, what I do not want to be is in the position of expressing a lack of confidence in the disclosure process—because I am a very strong believer in that process. It is, as you noted at the outset, a fundamental basis of our system.

Senator **Heinz**. I think we have to be candid about its limitations, if you see any limitations.

Mr. **Breeden**. There are situations. You have to recognize that the proxy process of course is in the hands of management, and that it is very common for investors who may have individually very small securities holdings, and who may not feel that they really can meaningfully affect selection of officers and directors, to give their proxy to management.

You also have large blocks of stock that are frequently held in a very few hands, of institutional holdings, where there may be a very strong tendency on the part of the individuals who vote those blocks of stock to give proxies on officer and director issues to management.

So it is not clear in the case where you might have an individual who had engaged in very, very serious fraud activity that every stockholder really would sit down and have a chance to read about it and say, "Is that the person I really want exercising fiduciary duties, enormous fiduciary obligations that an officer and director has?

So this is, we think, an opportunity not to have to put at risk the question of whether Jesse James is really going to get voted in as the person in charge of your investment. I do not want to sound undemocratic, because I do believe in the electoral process, and we try to make the proxy process realistic.

Senator Heinz. Chairman Breeden, I think you are on the right track there. But I would urge you and your staff to provide to the committee some real examples where disclosure requirements were met, by people who had violated the securities laws for fraud and who we would all agree, under a common sense test, should not have control of a public company.

We need that for the record. We cannot, I think, as conscientious legislators do it based on fairly general, if logical, assertions. Anything you can do to help us in that, we would appreciate.

Mr. Breeden. Certainly. I would be glad to.

[See response to written questions of Senator Heinz.]

Senator Heinz. Because we are going to get asked this question. Should we agree with you, and some of us are perhaps a little predisposed to agree with you, we have got to be able to answer our colleagues' very tough and quite appropriate questions on the subject at this point.

We need better information than so far we have. But that does not mean you will not be able to get it for us.

Mr. Breeden. That is a fair request, and I will be very happy to provide you with it.

Senator Heinz. Mr. Chairman, if I have time, I would like to raise the issue that I understand will be raised by some of our witnesses, regarding the six factors listed, starting on page 9 of the bill, that have to be considered, regarding civil penalties in administrative proceedings.

On page 9, it says that the agency may consider these six factors. Some have said that it should read "should" or "must" consider those six factors. The factors are, as I say, short, brief. They run through page 10 of the bill, about halfway through.

Chairman Breeden, what would happen if we changed the word "may" to "shall"?

Mr. Breeden. I think it would have about the same result.

Senator Heinz. You might be right on the first three. The fourth one is whether such person previously has been found by the Commission or other appropriate regulatory agency or self-regulatory agency, to have violated laws.

If you agreed to making factor number four a "shall," you would have to have somebody who is a bad actor, and caught as a bad actor once before.

Mr. **Breeden**. I do not think so. I thought you had asked the question not as to the word "shall," but "should."

Senator **Dodd**. No, "shall." Make it mandatory.

Mr. **Breeden**. In any event, I am quite confident that the Commission will, in fact, look at all those factors, to the degree they are present in a particular case.

Senator **Heinz**. Just to clarify what you are saying, are you saying that if we did change the word "may" to "shall," that that would be all right? I want to be very clear. If you are not prepared to answer, give it to us in writing, after due consideration.

I do not want you to say anything that you or the agency or shareholders are going to regret.

Mr. **Breeden**. The Commission would prefer the legislation the way we have suggested it, so that we may consider these factors. I will be very happy to give you a supplemental response.

Given the Commission testimony here, which we as a group have approved, I was suggesting that I think the effect is that there is not much need to change it to "shall." In effect, the Commission will always consider these factors where they are relevant.

Perhaps in the legislative history, it could be indicated that it is the expectation of Congress that these factors will in the normal course be reviewed. But we do not favor changing the statutory language from what I did suggest.

I think this is more of a syntactical issue than a practical one. Realistically the Commission will consider these factors where they are relevant, but we would like the law written the way we suggest it.

Senator **Heinz**. Now, in the legislation the Commission is seeking the authority to obtain civil monetary penalties against corporations. Doesn't the imposition of a fine against a publicly held company penalize the shareholders?

In other words, isn't the company's violation always caused by one or more individuals, and shouldn't they be the ones fined? Under what circumstances, do you believe it is appropriate to fine the company, as opposed to the persons responsible for violating the law?

Mr. **Breeden**. We traditionally do proceed against both individuals and against either partnerships or corporations as a collective entity. And certainly, thinking of, among other cases, the Drexel case or the Hutton case a few years ago, where an entire organization has engaged in a pattern of conduct that must have required the participation of a large number of individuals, it is not always practical to go against every individual.

There are cases where we believe it is appropriate to proceed against the entire organization.

Senator **Heinz**. Very well, Mr. Chairman. I thank you for the time.

Senator **Dodd**. Thank you very much.

Senator Pressler has arrived here. I would say to my colleague, we have somewhat of a crisis on our hands. We have one of our witnesses in the next panel who, if she does not get on in the next few minutes, will miss her flight.

Senator **Pressler**. We do not want that to happen. I will ask my questions for the record.

Senator **Dodd**. Just one last point. Senator Sasser and Senator Sanford wanted to be here today, but there are other hearings this morning and they could not be.

They asked me to ask you, a question which I will submit in writing, about an allegation of a 13(D) violation with respect to purchases of shares of the Cummins Corp. I would like to submit those to you.

Congressman Lee Hamilton also has written me asking that I submit a question for the record on the same matter, and I will do that also.

Senator **Dodd**. Thank you, Mr. Chairman, for 2 hours this morning. I have a dozen more questions for you, and we will certainly have ample opportunity as we move forward with consideration of this legislation to explore some of those questions.

Again, I thank you for your testimony, the written testimony as well as the oral testimony this morning. It has been of significant help to us, and we hope to move as quickly as we can.

There are a number of other requests that are pending, as I noted in my opening remarks, and as Senator Riegle did as well. We would ask you, just as soon as possible, to respond to those inquiries, so we can have the necessary information.

On that note, we thank you for being here this morning.

Mr. **Breeden**. For our part, I just want to reiterate the critical importance of both the market reform legislation that is now pending, and this legislation. We appreciate very much your efforts, those of Senator Heinz, and those of the other members of the subcommittee, in looking at these issues.

We will be delighted to continue working with you.

Senator **Dodd**. Our second panel is a very distinguished panel, and we are pleased to welcome them here. Stanley Sporkin, U.S. District Court Judge, former Director of Enforcement at the Securities and Exchange Commission.

He has had a very distinguished career. As I said, he was the Director of Enforcement. He has remained in public service since that time, as general counsel to the CIA; and now as a Federal District Judge. Judge Sporkin had a reputation for running a very tough and aggressive enforcement program, one that also was perceived as being very fair.

And I can tell you, Judge Sporkin, when I asked Chairman Breeden some months ago what he was looking for in an enforcement chief, he said he wanted someone just like you. That I think is about as good an answer as you can have to that question.

Thank you for coming here this morning. I guess in the interests of full public disclosure, I should point out as well that the person who makes this subcommittee really tick is not the chairman of it, or its members, but its staff. Marti Cochran is the staff director for the subcommittee. And for every good thing we do, I guess you can claim some credit, since she worked with you for about 5 years. And for everything we do wrong, you are going to be held fully responsible.

But Marti has done a tremendous job running the subcommittee. She has told me on numerous occasions how much she appreciated her years with you, and how much she learned, and the high regard and respect she has for you.

Ms. Peters, again, we thank you for waiting these few minutes. We are going to let you go first. We know Judge Sporkin will not mind. And then, if you have to leave, we will submit questions to you.

Ms. Peters is a very experienced litigator, a former SEC Commissioner, had a critical role in developing the enforcement legislation that we are considering today. We thank you for taking the time to be with us.

Victor Futter, I already have used your name once here. Mr. Futter is here today representing the Society of Corporate Secretaries. We appreciate your coming, and hope you do not feel outnumbered, by-the-way. We think you are so talented that you can handle this crowd of former enforcement officers.

And Gary Lynch, of course, Director of Enforcement at the SEC throughout most of the 1980's, was at helm when the SEC brought the biggest insider trading cases in its history.

So we have a very distinguished group of people with us, with a real knowledge of the legislation we are considering. We deeply appreciate your willingness to be with us.

Ms. Peters, we will listen to you first. Again, all of your testimony will be included in full in the record as if read. Proceed in the manner in which you feel most comfortable.

STATEMENT OF AULANA L. PETERS, ESQ., OF THE LAW FIRM OF GIBSON, DUNN & CRUTCHER, LOS ANGELES, CA; FORMER COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION

Ms. Peters. Thank you very much, Mr. Chairman.

I am very appreciative of the opportunity to testify before you and the other members of your panel today.

As you have very graciously acknowledged on the record, I have been long involved and very much concerned about the effectiveness of the Securities and Exchange Commission's enforcement remedies.

I have also been an advocate of increasing those remedies, and indeed have argued for a long time that the SEC should have the authority to fine and should also unequivocally have the authority to bar individuals from service as an officer or director of a publicly held corporation.

I think the first time I made these statements, dating back to October 1985, my opinion was firmly held then, and it has not changed. In fact, it has become even more firmly held in the intervening period of time.

I think Chairman Breeden did an outstanding job in giving you the background of the need, why the Commission needs these remedies, and in describing the flexibility. And I would underscore that; these remedies would afford the Commission increased flexibility in tailoring sections to meet the specific kinds of unlawful conduct.

I would not reiterate what I have already said in my written statement. If you would permit me, I would like to—perhaps a little presumptuously—address myself to some of the questions that the panel had put, since I will have to run in about another 4 or 5 minutes. Like most litigators, I am chafing at the bit to have my say on the questions.

I will start with one that occurred to me when you inquired about the cease and desist authorization that the Commission has asked for. Of course, this is a new element to the bill. It is one remedy that I think will be very useful, particularly if it is couched in a way that permits the Commission to act swiftly.

No matter how swiftly one can act and get the papers together to go into court, there is still the problem of comparing the memoranda, passing it through the Commission, and then going to court. That takes time. In an administrative forum, it definitely takes less time. So cease and desist would be a very helpful remedy.

You, Mr. Chairman, inquired as to whether or not it would not be a threat or undermine the economy of our Nation, because indeed the Commission does regulate and oversee a very important part of that economy; namely, the capital markets. And it occurred to me that we certainly should not—and I doubt very much that it would.

Mostly because, what the Commission has asked you for is authority to target unlawful conduct. And we are not talking about legitimate conduct. In my experience of four years at the Commission, I have found that the Commission and the staff—and most particularly the staff—are very slow to move, very cautious to move in any questionable case.

And I would expect, and I would think that you could count on, and that this Nation could count on the Commission being very judicious in its use of cease and desist activities, and using it in an instance such as those described by the Chairman where someone has a flagrant violation of the capital rules, or is conducting cold calls that really are a threat to the investing public.

Senator Heinz did ask a series of questions about the bar, what we came to call the "corporate bar" when I was at the Commission. I fully realize that that is probably the most controversial part of S. 647. So I would like to address some of those issues by perhaps reading my testimony, because it anticipated most of them, except perhaps for the disclosure question.

I would respond to the Senator that, in my opinion—and obviously it is just the opinion of one person—the disclosure rules and the philosophy underlying the disclosure rules, were first formulated some 50-odd years ago, and were really not put together with the viewpoint of having disclosure fix a wrong or remedy a wrong, as you perhaps more appropriately say.

They were put together with a viewpoint, as I understand it, to ensure that significant information about the issuing company and its securities got out into the marketplace, so that the marketplace would have an ability to evaluate these securities and put an appropriate price tag on them.

I am not confident that that disclosure does that, when you are trying to inform an investor, which is of course part of the marketplace, that management of the company has engaged in fraud or some other significant, unlawful conduct. Disclosure does not remedy that fraud, and it does not fix the manipulation that may have gone on. At least, that is the beginning answer to those who criticize the Commission for wanting to have this additional remedy made available to it.

I am confident that Chairman Breeden and the staff will be able to put out some examples of individuals who were sanctioned by judicial injunction, for example, two or three times, and yet again and again were elected to the board of directors or the inside management of a corporation.

Indeed, the Commission itself did not negotiate for and impose the bar of an individual from service as an officer or a director of the corporation, until it had been determined that this individual was a repeat violator.

The next step of course is to see what the annual report said about those violations. But I assure you that an able drafter can describe a 10(B)(5) injunction so that it sounds like nothing at all. And the remedy of eliminating the danger from the capital markets and from the investing public still remains.

Insofar as the corporate bar constitutes an intrusion into the area of corporate governance, which as we know is indeed the province of the States, I would point out that already the capital markets or securities markets are clearly an area designated for Federal concern and Federal control.

In some respects, it is not exclusive, but the Federal Government is there and has a statutory responsibility that is implemented by the Securities and Exchange Commission to control and oversee and regulate those markets. So that should, from my point of view, be the end of the questioning. I realize, however, that it is not.

And I would point this panel to precedent in prior Commission activities that it would seem to me on reflection would constitute an even more severe intrusion into corporate governance. In areas that the corporate bar is not the Commission has repeatedly in the past ordered companies to establish audit committees, ordered companies to open their doors to receivers and special masters who spend a year or more investigating the company and making again recommendations as to how that company should change its operations and conduct its business activities, its business activities in the future, all with the view to ensuring that the company itself is the type of company that one can with comfort permit the public to invest in.

I think that when you compare the corporate bar, this proposed legislation, as it relates to barring of individuals from service as corporate officers of directors, that that remedy—well, it does not exactly pale. I do not like to exaggerate, because one makes oneself a target when you do. But it is certainly analogous to and comparable to other remedies that it has long been recognized that the SEC is entitled to receive.

With that, gentlemen, I would wrap up my remarks, and invite you to put any questions to me that you would care to put.

[The complete prepared statement of Aulana L. Peters follows:]

TESTIMONY OF AULANA L. PETERS BEFORE THE SECURITIES SUBCOMMITTEE OF THE UNITED STATES SENATE COMMITTEE ON BANKING HOUSING AND URBAN AFFAIRS

In October 1985, I first stated publicly an opinion I had held for some time which was that Congress should give the Securities and Exchange Commission (the "Commission" or the "SEC") the authority to impose civil money penalties as sanctions for violations of the federal securities laws. It was my view then, and it remains so today, that the Commission's ability to sanction effectively certain violators and violations of the law is limited and more importantly, is not sufficiently flexible. S.647 provides the additional flexibility and clout the SEC needs to police more effectively the United States securities market, in that it will permit the SEC to seek the imposition of civil money penalties and will expressly authorize the imposition of a bar of an individual from service as an officer or director of a public company.

Providing a regulatory agency the authority to impose fines for violations of the laws it enforces is hardly a novel or revolutionary concept. Any number of governmental agencies have this option available to them. Therefore, rather than focus this testimony on the acceptability of the concept, I would like to highlight what in my view are some of the advantages that would result from providing the Commission with such a tool to aid in the pursuit of its charter.

First, fines could be used to call attention to the egregiousness of a particular violation. Escalating fines provide a barometer by which the public could measure the significance of the violation. Moreover, a fine, coupled with an injunction or an administrative remedy, would also signal the seriousness with which the Commission views the unlawful conduct in question. Similarly, the ability to fine would provide the Commission with a meaningful way to distinguish between different levels of culpability in a multiple party enforcement proceeding. What is perhaps more significant is that civil money penalties may be used in certain situations where a censure is not enough, but revocation or suspension of a license would be draconian sanction. In sum, the ability to fine will enhance the Commission's ability to tailor a sanction to particular unlawful conduct.

Another benefit of civil money penalties is the deterrent effect they may have on repeat offenders. The Commission frequently must deal with recidivists who, at times, appear to take pride in scoring another notch on their belts each time they are enjoined. In such cases, fines would increase the downside risk of violating the securities laws. Fines are a viable and legitimate means for deterring unlawful conduct and punishing those who do violate the law.

In addition to authorizing the imposition of civil money penalties, S.647 would authorize the Commission to seek to bar individuals from being an officer or director of a public company. Of course, the Commission has the statutory authority to bar registered representative, broker-dealers, and investment advisors from the securities industry. Moreover, through Rule (2)(e), the Commission has some measure of control over who may practice law and accountancy before it as a regulatory body. However, the Commission continues to be plagued with the problem of what to do about the irrepressible entrepreneur who consistently and repeatedly misleads the investment public through false prospectuses, registration statements and periodic reports.

The concept of a "corporate bar" is to provide a remedy for egregious violations of the law, particularly by repeat offenders demonstrably indifferent to the strictures of the securities laws. Barring such persons from acting as corporate officers or directors would be and is in many situations the most effective way to protect the public investor. This remedy has been considered by some as novel, and even unprecedented because it is being applied to non-securities industry professionals. Whether novel or not, it is an extremely useful concept that would aid significantly the Commission's efforts to police the capital markets.

In view of the fact that the "corporate bar" aspect of S.647 appears to be more controversial than the civil money penalty provision, I believe it may be beneficial to focus on the fact that the concept is not particularly revolutionary rather than the advantages that flow to the Commission from its use. The latter will be obvious once the former is clear.

It has been argued that establishing a bar from office in a publicly held corporation as a remedy for violations of the federal securities laws would be an inappropriate incursion into an area generally governed by state law (namely, the determination of who is qualified to serve as an officer or director of a corporation). Moreover, it is also said that such a remedy runs counter to the federal philosophy of protecting shareholders through disclosure. In my view, assuming, for the sake of argument only, that this proposed remedy constitutes an incursion into state law, it is a permissible one that is well within a substantive area already subject to federal control. More importantly, the approach adopted in S.647 would not constitute an a priori barrier to the national market place. It would operate as a post facto denial of a privilege based on violations of the rules from which the privilege derives. Significantly, the Commission has already exercised analogous authority in adopting the "bad boy" provisions of Rule 505(B)(2)(ii) and 252(c), (d), (e) or (f) of the Securities Act of 1933 which act as a *de facto* administrative bar under Regulation D and Regulation A respectively.

Another concern expressed about the Commission's use of a corporate bar or suspension as a remedy is that it amounts to a denial of access to our national capital markets and smacks of merit regulation. In response to such objections I would point out that:

-- Since 1933 there has been no unfettered "right" to access to the national capital markets -- access is conditioned on compliance with federal securities laws.

-- Imposition of a bar does not preclude first time entry or even second time entry -- it operates against those who can not or will not comply with the law.

-- The remedy does not say the offender cannot be a businessman or entrepreneur, just that he or she within a narrow context cannot raise capital from the public, or within a broader context, cannot manage a public corporation.

In the broader context, it is worth pointing out that Congress empowered the Commission to seek equitable relief for violations of the securities laws through the courts. While Section 21 of the 1934 Act specifies the kind of relief the Commission may seek, it does not expressly preclude requests for other kinds of relief. Moreover, both the Commission and the courts have acted under the assumption that the Commission may, as may any other litigant, appeal to the court's plenary equitable powers to fashion appropriate relief. Thus, the Commission has been able to obtain ancillary relief under the 1934 Act in the form of receivers, disgorgement, audit committees, and accountings. In the context of a judicial proceeding, a bar from corporate office is simply another form of ancillary relief. It is certainly no more intrusive into corporate governance than requiring the formation of an audit committee or the appointment of a special master to examine the corporate policies and procedures, all of which remedies the Commission has consistently and repeatedly obtained.

S.647 represents a much needed amendment to the Federal Securities Laws. In some respects, the SEC's ability to enforce effectively the securities laws is limited by the remedies it has available to it. The additional sanctioning power provided by S.647 would significantly assist the Commission's enforcement efforts by giving it more flexibility and clout.

Senator DODD. Thank you very, very much, Ms. Peters.

You anticipated a lot of the questions certainly that I would have had for you, and Senator Heinz as well.

Again, at any moment if you feel you should leave, go ahead. We will submit some questions to you in writing, as necessary.

We thank you very much.

Ms. PETERS. With your permission, I will get on my way to the airport. I would be glad to entertain further additional questions that you may have. I would also be glad to meet with you before this panel.

I would urge you to pursue this legislation. And I certainly hope to see that it is adopted sooner, rather than later. Thank you.

Senator DODD. Thank you.

Judge Sporkin, we thank you for being here this morning, and all of you for being patient in listening to the Chairman's testimony.

STATEMENT OF STANLEY SPORKIN, U.S. DISTRICT JUDGE, WASHINGTON, DC; FORMER DIRECTOR OF ENFORCEMENT, SECURITIES AND EXCHANGE COMMISSION

Mr. SPORKIN. Mr. Chairman, I want to tell you how pleased I am to be here. I certainly appreciate your invitation.

I feel like the old, retired fireman, who when he sees a fire, has to come back to a fire. Having spent 20 years at the SEC, I find that while you can take the person out of the SEC, it is hard to take the SEC out of the person, when it comes to issues of this kind.

I am just going to briefly hit some of the highlights of my statement.

I believe that each of the proposed new sanctions is supportable on the basis that they would measurably enhance the vigorous enforcement of the Federal securities laws. I might add that providing the SEC with additional enforcement sanctions could also be helpful to the defense bar. By giving the SEC and the securities defense bar these additional sanctions, the ability of the Commission to more expeditiously dispose of matters on the basis that is fair to all parties would be enhanced.

One of the problems I found when I was at the Commission was that at times when you were sitting down with very responsible members of the defense bar—and this defense bar probably is as good as any you could find in the country—you did want to settle the matter and resolve the matter. The securities laws simply did not always provide the parties with an appropriate sanction.

I believe here that the new sanctions the Commission asks for, would be extremely helpful. A fine would be helpful. It becomes very pertinent at times to have a fine, particularly, as I say in my statement, where you cannot find a victim, you cannot identify who the victim is. Or, sometimes the victim may not be worthy of receiving any money. The victim himself may have been part of the underlying activity. And so it is helpful.

Also, it is a way of assessing or spreading the costs of enforcement, because it imposes a cost directly on the people who have caused the enforcement machinery to come into play.

Now, with respect to the disciplining of officers or directors of major industrial concerns, that is a provision whose time should have been here 10, 15 years ago. I had that suggestion back in 1978, but because I realized that it would cause a lot of concern, particularly if I made it—[laughter] I did not make it.

It did not get very far.

But I see no reason why an officer or director of a major industrial complex who violates the law should be dealt with any differently than a banker or broker. A banker now who gets into trouble, you can bar him from being a banker. A broker that gets into trouble, you can bar the broker. Even though banks can be registered in States, and even though brokers may be public brokers with their charters from particular States.

The public needs protection from dishonest managers of industrial concerns, just as it does from unprincipled bankers or brokers.

Now, I realize that some will say that this proposal is another example of overregulation. I heartily disagree. And I say that because what we have here—and this I think is the genius of the proposals that were made—the form of regulation proposed in the draft legislation is of minimal intrusiveness.

Here, you have the concept of regulation by exception. Everybody is qualified to be a director or an officer of a company. You do not have to go through any kind of a process or procedure. You do not have to demonstrate your qualifications. There are no qualification requirements for service. Indeed, as it presently exists, anybody can serve in a corporate position.

Now, under your proposed legislation, an individual disqualifies himself or herself only where that person has transgressed or violated the law. So you say, "Come on in. But if you violate, you are out." There is no additional cost of regulation, you do not need any elaborate regulatory mechanism to be constructed. It is there. It is already in place.

I should also point out that the Commission, largely through the consent decree process, has been exercising this power in fact for many years. And where officers and directors are proceeded against in a criminal forum, when convicted, they can be deprived of corporate office.

So the arguments we hear, that this authority is exclusively for the States to exercise, do not make much sense. Because, for example, if I have a corporate director before me who has been convicted of a crime, as a condition of his supervised release I can limit his participation as a corporate director. So that is already there. What we are now saying is, there should be a more direct method for dealing with the problem.

The Commission also, in its consent decree process, has done that on numerous occasions. I did it when I was at the SEC. People have voluntarily agreed not to serve as an officer or a director.

So it is extremely important for the Commission to have this power. And I might say that I think that the Commission is now trying to meet the concern by saying it would only be used in the most egregious cases where there is a violation of the fraud provisions. I would suggest to you that probably is going much further than they should go, and I will give you examples of cases that I had where it should have been exercised, where you had what I call "dummy directors."

One case—and I will not mention the name—but it was a case where every director of a board of a major corporation gave a signed but undated letter of resignation to the chairman of the board, without any disclosure of that fact. So that at any time that the chairman of the board of this company wanted to get rid of them, all he had to do was to put the date in, and they were gone.

These people had not violated any fraud provision. But I say to you, that they should not be able to serve on any corporation where they do not understand what it means to be a director of a corporation.

We had another case in which, again, three directors allowed the overbearing chief executive officer to do what he wanted. Why? Because they were getting paid the directors' fees. They did not care. And again, we had to discipline them through a release to state what they had done. But that is another situation where the person should have to give up his right to be a director.

There has been discussion about a bar against the directors as being too onerous, and what I am suggesting is, the way you temper that is that not everybody should be barred for life. Even Pete Rose, for example, said that he is going to try to get back after a year. So I would say that it not be a total bar, but it be just like the Commission's authority against brokers, in which a broker can be suspended or barred for a period of time. But at least persons should realize what it means to serve in a public corporation, what it means to serve as a director of General Motors. They do have obligations.

So I say, it is an important power. And instead of causing concern, it is one that I think is going to enhance the reputation of corporations.

Now, the finding power, I just, again, think that is appropriate, and I think that the Commission makes a dichotomy there when it says certain people can be dealt with in an administrative forum, and certain people in the courts. I leave that up to the Congress. I do not see much concern there.

On the 16(a) proposal, obviously it is necessary for the Commission to be able to move in that area. That is because 16(a) originally was the key provision to deal with insider trading. Congress foresaw that insiders who bought and sold securities within a six-month period must forego their profits.

It is a very important provision. It is important that the public know what insiders are buying or selling. And I believe the Commission ought to have the right to proceed against them in an administrative form.

The only question that I had on the cease and desist power which the Commission wants, and I think they ought to have, is that there is one concern that I have and that is simply this:

By giving the Commission nationwide authority over anybody that gets involved in buying or selling stock, could cause a problem. And let me give you an example.

There are many cases that you have where it is "man-bites-dog," where an individual may well have taken advantage of a brokerage firm, or maybe get credit extended improperly. These are usually little people, people in Iowa, people all over the country. And this is something that I consider at the SEC—because I believed at the time we should have cease and desist power—but I do think that you are going to have to accommodate the people that are not really in the mainline of securities regulation.

In other words, I do not mind the Commission having that power with respect to corporations, its officers, and directors, because they are regulated and directed by the Commission; nor with respect to brokers, investment advisors, or investment companies.

But with respect to Aunt Tilly, or Aunt Annie, who might not have paid their money on time, or violated the credit provisions, I would think that you are going to have to maybe not carve them out, but give them at least the right to remove the action to a court, because they might feel that they would be more fairly dealt with than having somebody in Washington issue this order, and then they have to appear before an administrative agency.

So I would only mention that as a way to deal with this problem. Either you allow them to remove it, or else carve out that group of people who are not involved every day in SEC matters.

That is all I have to say.

[The complete prepared statement of Stanley Sporkin follows:]

Statement of Stanley Sporkin
Before the Securities Subcommittee,
Committee on Banking, Housing, and Urban Affairs
Thursday, February 1, 1990

I appear today at the request of the Subcommittee to share with you my views on certain Legislative Proposals to enhance the Securities and Exchange Commission's enforcement program. My appearance has been requested because of my prior service as the Director of the Securities and Exchange Commission's Division of Enforcement from 1974-1981.

It is my intention to discuss whether the proposals will better serve the interests of the Securities and Exchange Commission and the public. Although it goes without saying, none of my testimony in any way reflects any views I might have as a result of the position I now hold.

I believe that each of the proposed new sanctions are supportable on the basis that they would immeasurably enhance the vigorous enforcement of the Federal securities laws. I might add that providing the Securities and Exchange Commission with additional enforcement sanctions could also be helpful to the defense bar. By giving the Securities and Exchange Commission and the Securities Defense Bar these additional sanctions, the ability of the Commission to more expeditiously dispose of matters on a basis that is fair to all parties would be enhanced.

In my day there were many cases in which a fine paid into the Treasury of the United States would have been the most appropriate sanction to impose in the public interest. The same could be said for giving the Securities and Exchange Commission the right to discipline directors and officers of major corporations.

Indeed, as far back as 1978 I advocated giving the Securities and Exchange Commission the power to disqualify directors where they had violated the federal securities laws. I take no position as to which juridical authority - the Securities and Exchange Commission or the Courts - should have the power to impose such a sanction.

I see no reason why an officer or director of a major industrial complex who has violated the law should be dealt with any differently than a banker or a broker. The public needs protection from dishonest managers of our industrial concerns just as much as it does from unprincipled bankers or brokers.

I realize some will say this proposal is just another example of over-regulation. I heartily disagree. I have been a constant critic of too much regulation. Here is what I said in an address I delivered to a Bar Association group this past October:

> As we position ourselves for the last decade of the 20th century and the beginning of the 21st century, we must remove those impediments which will prevent our financial markets from realizing their full potential. We must plan for the future. This does not mean that there must be complete deregulation, or no regulation, because the contrary case clearly has been made. But regulation must have a purpose that is compatible with the great economic system we now enjoy. Indeed, as has been demonstrated by what recently has taken place in The Soviet Union, China, Poland, and certain other of the communist bloc countries, we enjoy the finest economic and political systems that any nation has ever devised.

> The competition with communism essentially is over. Our capital market and political systems now clearly have surpassed their competition. They will continue to be strong only so long as they adhere to the basic principles that made them the best in the world. This means a system with the fewest impediments and restrictions to capital formation and commerce. As our overall goal we should regulate only to assure that our markets are fair, honest, fully competitive, and accessible to all.
>
> The dynamics of our financial markets require a dramatic restructuring of the regulatory mechanism. We must eliminate duplicative and mindless regulation. We must permit access to the market place for new and budding enterprises with the minimum restraints. Whatever new forms of regulation are considered, they must be examined in the context of an evolving society designed to be driven by the innovation of the private sector and not an impediment to it. We must make sure that the creativity of our brilliant scientists and entrepreneurs is not stifled by suffocating regulation.

The form of regulation proposed in the draft legislation is of minimal intrusiveness. Here you have the concept of regulation by exception. There are no qualification requirements for service as an officer or director. Indeed, as presently exists, anybody can serve in any corporate position. Under the proposed legislation, an individual disqualifies himself or herself only where that person has violated the law. No elaborate regulatory mechanism need be constructed. The disciplinary machinery is already in place. I should point out that the Commission largely through the consent decree process has been exercising this power in fact for many years. And where officers and directors are proceeded against in a criminal forum, when convicted, they can be deprived of their corporate office.

This proposal empowers the Securities and Exchange Commission to deal with errant corporate officials directly rather than overusing the consent decree process or invoking the criminal justice system. This proposed "regulation by exception" certainly deserves your careful consideration.

The ability to assess a fine could also play an important role in the Securities and Exchange Commission's enforcement program. When I was Director of the Division of Enforcement, there were many cases where I would have liked to seek money penalties against securities law violators. This is a common power enjoyed by many other regulatory authorities. It can prove most helpful in cases where it is difficult to locate persons who have been victimized. Where criminal charges have been brought and sustained, the imposition of a fine against the wrongdoer is commonplace. One important rationalization for the imposition of a fine is that it helps to reimburse the Government for the cost of conducting its investigations and proceeding against law violators. In other words, it directly assesses the costs of law enforcement against the perpetrators of wrongdoing.

The authority the Securities and Exchange Commission seeks for proceeding against officers, directors, and principal stockholders in an administrative forum for violation of Section 16(a) of the Exchange Act also seems to be a reasonable proposal. This provision is one of the Commission's important tools for policing insider trading. Clearly, the Securities and Exchange Commission should have the authority to proceed quickly against those who would transgress this key provision of the federal securities laws. With the increasing globalization of the securities markets, certain unprincipled corporate insiders might find a greater temptation to take advantage of their privileged position by engaging in secret stock transactions overseas on the premise their trading would not be discovered. When such activities are found out, the Commission should be able quickly to proceed to enforce this important provision.

As you can see from my testimony, I believe these three proposals are modest, and would provide the Securities and Exchange Commission with important new weapons to discharge its enforcement function. With the securities markets expanding both domestically and internationally, the Commission needs all reasonable enforcement measures. Indeed, I believe eventually we will need an international overseer of the markets to carry out the necessary market policing functions. But until an international securities and exchange commission is established, our domestic Securities and Exchange Commission will need enhanced powers.

I would be glad to respond to your questions.

Speech by Judge Stanley Sporkin before
The 22nd Annual Los Angeles
Securities Regulation Seminar
November 2, 1989

SECURITIES AND FINANCIAL MARKET REGULATION IN THE 1990's

It was the most creative of times and the most unsettling of times. I guess that statement sums up where we are today and where we most likely will be during the remainder of this century. It is quite clear that the technological revolution that now engulfs us still has plenty of steam and will continue at its present pace throughout the next decade and into the twenty-first century. The changes that this revolution has wrought are so dynamic and fast-moving that it is really difficult to get a clear picture of the future.

Our society is changing so fast that major institutions once thought to be impregnable are now in real jeopardy. I need only cite you a few examples to prove this point. As most of you will recall, it was just a few years ago that IBM dominated an industry that sold a product called the typewriter. I am sure those at IBM believed their dominant position in the industry would forever go unchallenged. Then, of course, came a gizmo called the word processor and the typewriter which had been with us for many decades became history literally overnight. In recent times we also have seen those gorgeous watches with the fine Swiss movements being replaced by time machines powered by the micro chip. Thus another major industry bit the dust. I also invite you to look where such longtime industry leaders as

Xerox and Kodak are today. Old Ma Bell ain't what she used to be and indeed the entire telephone industry has also undergone dramatic and rapid change in recent times. I might add that I would not be going too far out on a limb by suggesting to you that even such a fundamental and monopolistic institution as the Post Office probably will undergo radical changes and most likely will not exist in its present form in the next five years or so. Just look what impact the Fax machine has already had on our first class mail delivery system. I cannot recall any period in the past where change has been so dramatic and rapid. What we are seeing is literally happening before our eyes.

While the examples I have given all pertain to the demise of old line industries and products, even relatively new technologies are now entering their second, third, and fourth generations. For example, the state of the art personal computer I bought just some three years ago is now outdated, and the cable industry that is really still in its infancy will likely be challenged in the next five years by the miniaturized satellite dish that you will place on the window sill of your home.

I bring up these examples only to make the point that these technological, economic and societal changes so permeate our society that they will have a substantial impact on the future structure and performance of our financial markets. There is literally no segment of our society that is immune from these deep seated changes. Indeed, I would suggest to you that this technological revolution is in large measure responsible for the restructuring that is now taking place in the communist bloc countries. Yes, my friends, the microchip has had an impact on world politics.

Against this background it is quite clear to me that the most fundamental marketplace restructuring will occur in the international arena. True globalization is right around the corner. Yes, let us start getting used to the fact that the United States will no longer be the dominant player it has been in the past. Indeed, as I have said in other talks, we will eventually see an international market oversight organization. A world wide SEC with the United States being just another "Blue Sky" State. The recent mega mergers of certain of our Big Eight accounting firms are but a first step in their positioning themselves for globalization. When such a conservative and staid profession as the accounting profession goes global, then we know that change is in the wind. Our major law firms and the other servicing components of our securities and financial markets probably shortly will follow the number crunchers. The one world financial market in my view is about to become a reality.

What I just described is the macro view. On a micro basis there also are going to continue to be enormous changes. At this time the private sector has outpaced the regulators' ability to adequately regulate our domestic financial markets. Regulation has been unable to keep up with the creativity and inventiveness of the private sector. Although changes in the private sector have been far reaching, regulation of our financial markets remains virtually the same as it has been during the past fifty years, with the one major exception being the very recent changes that have been put into effect with respect to the oversight of our thrift industry. While the private sector has been trying to develop the concept of a financial supermarket with all financial products being made available under one roof, the regulation of our financial markets continues to be Balkanized. It sometimes is difficult to appreciate how much progress has been made in the private sector in spite of the almost suffocating and overlapping regulatory scheme that overlays our securities and financial markets. We have the Securities and Exchange Commission, four or five bank regulatory organizations, the Federal Trade Commission, the Antitrust Division of the Department of Justice, and the Commodity Futures Trading Commission - all on the Federal level. Then there are five or six self-regulatory organizations and fifty state commissioners that exist in the securities field alone. Now, I do not think anybody would be too concerned with all this regulation if it were effective and efficient. The fact is that efficiency and effectiveness presently do not exist. I need only cite the recent horrendous debacle that took place in the thrift industry to make this point.

Even in the Banking area where we just experienced the massive restructuring of the thrift industry, multiple Federal regulatory agencies continue to exist with problems that normally attend overlapping regulation. In recent days the following statement appeared in the **Washington Post**:

> A new feud among federal banking regulators flared yesterday when the comptroller of the currency stepped into a dispute over how much capital owners must invest in their S&Ls.
>
> Described as 'a regulatory donnybrook' by House Banking Committee member Jim Leach (R-Iowa), the disagreement pointed up the interdependence and infighting among the half dozen agencies that now have roles in regulating banks and S&Ls--the Federal Deposit Insurance Corp., the comptroller, the Federal Reserve Board, the Office of Thrift Supervision, the Treasury Department, the Resolution Trust Corp. (RTC) and the RTC Oversight Board.
>
> ***
>
> Congressional banking committee sources said the dispute points out again what happens when three agencies regulate three different kinds of banks and a fourth agency is in charge of thrifts.

While the new thrift bill concededly was necessary to the survival of that important industry, it appears that the legislation did not bring about a real streamlining of the oversight process.

I am not trying to use inefficient and ineffective regulation to justify entirely the need for regulatory reform, because there is actually a more compelling reason. As we position ourselves for the last decade of the 20th century and the beginning of the 21st century, we must remove those impediments which will prevent our financial markets from realizing their full potential. We must plan for the future. This does not mean that there must be complete deregulation, or no regulation, because the contrary case clearly has been made. But regulation must have a purpose that is compatible with the great economic system we now enjoy. Indeed, as has been demonstrated by what recently has taken place in The Soviet Union, China, Poland, and certain other of the communist bloc countries, we enjoy the finest economic and political systems that any nation has ever devised.

The competition with communism essentially is over. Our capital market and political systems now clearly have surpassed their competition. They will continue to be strong only so long as they adhere to the basic principles that made them the best in the world. This means a system with the fewest impediments and restrictions to capital formation and commerce. As our overall goal we should regulate only to assure that our markets are fair, honest, fully competitive, and accessible to all. It also goes without saying that we must assure that our great industries will continue to provide a national defense that a world class nation needs to assert its world wide leadership. Moreover, under no circumstance can we allow the great freedom of our system to work in a way that produces extreme excesses that in the long run will defeat the very system that we want to flourish. With that said, let us examine some of the reforms that are needed to foster these goals.

The dynamics of our financial markets require a dramatic restructuring of the regulatory mechanism. We must eliminate duplicative and mindless regulation. We must permit access to the market place for new and budding enterprises with the minimum restraints. Whatever new forms of regulation are considered, they must be examined in the context of an evolving society designed to be driven by the innovation of the private sector and not an impediment to it. We must make sure that the creativity of our brilliant scientists and entrepreneurs is not stifled by suffocating regulation.

The first element that needs to be considered to achieve these lofty goals is the de-Balkanization of the present regulatory scheme. As you know, the new word in merchandising is the so-called "lite" product. Thus we must now proceed with the concept of regulatory "lite." That means we must slim down the multiplicity of regulatory organizations to avoid as much duplication as practicable. At the same time, we must make regulation more effective. Our system cannot tolerate another multi-billion dollar S&L debacle. There are several ways to accomplish this goal. One way would be to establish an umbrella organization to fashion the overall regulatory scheme with a second agency to enforce the regulations adopted. The reason for a single standard setting regulatory organization is to be able to deal with the emergence of the financial supermarket concept that, although it is now only in its developmental stage, offers great promise to assure the continued viability of our capital market system. Of course as we proceed in this direction, we must do so with caution. Paramount consideration must be given to safeguarding our deposit insurance system which is so fundamental to the sound operation of our banking system.

The rationale behind a single unified enforcement arm is to assure that an organization that is dealing in a multitude of products will be precluded from operating where it is not acting responsibly in any of its various business phases. This concept would in effect recognize that functional regulation simply is unworkable. What did not make sense to me when I was Director of Enforcement at the Securities and Exchange Commission was that when we discovered a brokerage firm was cheating its securities clients we were without jurisdiction to examine the firm's non-securities operations. It was obvious to me that a firm that would churn a customer's securities account would do likewise with respect to that customer's commodities transactions. This jurisdictional impediment made us at the SEC look like a bunch of Inspector Clouseaus.

Functional regulation also runs the risk of making the functional oversight regulator a cheer leader for the particular market segment it regulates. While the SEC up to this point has generally acted quite prudently in avoiding becoming the captive of those it regulates, this clearly cannot be said about other regulatory agencies. Indeed, much has been written about the race to the bottom among competitive regulatory agencies. And to those who say a single enforcement agency is unworkable, I would only refer them to our present system of criminal enforcement where one agency, namely the Department of Justice, has fared very well in enforcing all of this nation's Federal Criminal Statutes.

If the regulated are able to cross functional lines, the regulators should be able to do the same. So for those who advocate functional regulation, I suggest they reconsider that view. It would only perpetuate the Balkanization that now exists.

I hope I have given all of you something to think about during your deliberations. I know some of you have become comfortable with the status quo. I would suggest to you that such complacency in the dynamic world we now live is the path to oblivion.

Whether what I propose is the answer is not important. What is important is that our private and governmental sectors must be able to function together. If they don't, then we stand the real chance of losing our world-class leadership role.

While up to now we have been discussing our securities and financial markets and their regulation, I also want to take a few moments to share with you what I see coming in the 1990's and the next century with respect to the various professions that have a very keen interest, monetary and otherwise, in the operations of our securities and financial markets. We are presently observing truly unbelievable changes in the accounting profession. I do not believe as little as two years ago anyone would have predicted that the Big Eight would become the Big Five and perhaps eventually the Big Two. I hesitate to say the Big One, because I think there will be sufficient conflicts that will demand there be at least another mega accounting firm. Globalization seems to be the main reason for this consolidation movement. I think this trend toward huge world wide participatory entities will also take place in the legal profession. I foresee huge legal firms establishing branch or satellite offices in virtually every major city in the United States. This will put the old line large local firms under tremendous competitive pressures. While certain of these firms may have trouble surviving this onslaught, the "boutique" specialty firm will survive. This is because small litigation, securities, or other specialty shops will be able to deliver expert services at a cost considerably below their larger rivals.

While I believe the broad outlines of what will take place in the next decade are clear, it is difficult to discern the detailed way these changes will occur or the precise contours of the system. As a matter of self preservation, it is imperative that each and every one of you focus on the future and not be so shortsighted as to believe that just because things are going well today they will remain that way in the future. If there is any lesson we can learn from the past decade, it is that nothing is certain any more. You must keep your eye on these recent trends and not dismiss them as something that pertains only to others. You must position yourself so that you do not end up like the IBM typewriter, or the Swiss watch, or as the nice fellow that delivers your mail might end up in the next few years. As an old friend of mine has said, "If you fail to plan, you are planning to fail."

I thank you for the opportunity to share these thoughts with you.

Senator DODD. That is a very good suggestion. I think it is a very good provision to have.

But there is a concern I have, and I think you have identified it, that that would place tremendous economic burdens on people who are just not in this business.

Gary, we thank you for being here today.

Senator HEINZ. Before Gary Lynch starts, Mr. Chairman—and I do welcome this panel—I just learned that Senator Dole has called a meeting of certain of us who are involved with the Clean Air Act, in his office at noon. I had hoped to be able to be here for the duration, but I will have to leave shortly.

Senator DODD. If you would like to, why don't you submit some questions? I am sure our panelists will not mind. If you would like to, make them now.

Senator HEINZ. There is one, and I would appreciate it.

Senator DODD. Then we can come back to you.

Senator HEINZ. I thank Mr. Futter for his forbearance here.

This is a question for Gary Lynch that occurred to me when I was listening to Richard Breeden. It is a privilege to have two former enforcement directors here. You are less "former" than Judge Sporkin, so I am going to put this one to you, Gary.

While you were director of the division, I am sure you heard complaints from defense lawyers that the SEC's administrative proceedings did not provide the same protections for those accused of securities law violations as a court of law. Some clients see the administrative proceeding as a case before a house judge with house rules.

Now that you have been a member of the defense bar, are you concerned that the proposed authority to obtain civil monetary penalties as well as cease and desist authority, will shift more enforcement cases to administrative proceedings? Are there improvements that could be made to administrative proceedings to address these concerns?

Mr. LYNCH. I think it is clear, particulary with the changes in S. 647 that Chairman Breeden suggested this morning, that the percentage of enforcement cases that result in administrative proceedings, rather than injunctive actions, will increase.

Clearly, there will be more incentives now to go to administrative proceedings.

Senator HEINZ. That goes without saying.

Mr. LYNCH. I do not have a concern about the fairness of administrative proceedings. It is clear, though, and I would add this point quickly, that there are fewer procedural protections in administrative proceedings than there are in civil actions litigated in Federal court.

For example, there is no opportunity for a respondent in an administrative proceeding to have discovery before the hearing occurs.

Senator HEINZ. So how serious or significant is that?

Mr. LYNCH. I think it can be a concern in some cases; particularly, if you are dealing with people who really are not in the industry, to pick up on a point that Judge Sporkin made. If you are dealing with people who are not with regulated entities, or in cases with a complex set of facts, and now if the Commission receives firing power I think it is more of a concern.

Up to this point, most of the administrative proceedings that have been brought by the Commission have dealt with issues pertaining to the brokerage industry or investment advisory industry. And the respondents in the cases for the most part have been from those industries.

So I think that is somewhat of a concern going forward. I cannot say it is a large concern. But I would hope that the Commission will focus on the procedural protections that are provided for in the administrative process, and perhaps enhance somewhat some of those procedural protections.

Mr. **SPORKIN**. If I could just mention, Senator Heinz, I do not have those concerns, and I will tell you why. And I think Chairman Breeden hinted in his testimony, which I thought was extraordinarily good—I am glad to see that they still write so well over there—[Laughter.]

Senator **HEINZ**. Judge Sporkin, if I might say so, you are quite a piece of work. [Laughter.]

That is a compliment.

Mr. **SPORKIN**. I will take them any way I can get them. [Laughter.]

But the point is that, whatever the Commission does in an administrative forum is going to be reviewed not by a district court but by a court of appeals. And they have been very rough on the Commission, if you look at the cases.

There is a case that the SEC has had now—I do not know—for 5 to 10 years, trying to deal with a particular broker in the midwest, and they are still trying to deal with him. Because every time they go up to the court of appeals, the court of appeals sends the case back and says, "You did not cross the 't' and dot the 'i'." And if you look at the court of appeals in our circuit, it is tough.

So I do not have that concern.

Senator **HEINZ**. Do either of you want to comment on the "shall" and "may" issue that I raised with Dick Breeden?

Mr. **SPORKIN**. I think, "shall" is all right, if it is not a preclusion—in other words, if someone has not violated the law before, he could still be fined. And I say fine.

Senator **HEINZ**. That is, they "shall" consider these factors, and they do not have to find in the affirmative in each one?

Mr. **SPORKIN**. Therefore, I do not have a problem.

Senator **DODD**. Let me raise a concern about just that point you made on the last question, regarding the appeals process. There is some concern that you would run the risk of exactly what you described when an appeals court reviews a decision with that "shall" rather than "may."

Mr. **SPORKIN**. As Chairman Breeden said, you will correct that in your legislative history by saying "shall." It does not mean that if one of these criteria are not present, they shall not be able to act.

Mr. **FUTTER**. Mr. Chairman, before Senator Heinz leaves—because it is his question—I have a slightly different point on that. I wonder whether I might comment?

Senator **DODD**. Certainly.

Mr. Futter. I do not think the "shall" quite does it, Senator. What we have been talking about this morning for the most part is egregious, fraudulent conduct, malfeasance of the worst type, false market information or manipulation..

I think you need something like that in the statute to indicate you have been talking about that sort of activity or about repeated violations. Now, I think that you should be requested to have a finding of that sort of conduct before you can impose a penalty as drastic as those proposed in the bill.

Therefore, I suggest to you that you look at the language of the various subdivisions of the bill. While some of the subdivisions need only be considered, for others, to my mind, a finding should be required. This will more appropriately achieve the purposes of this legislation—which I fully support—to put out the evil-doers out of the corporate world.

But to some extent, this legislation, as I will comment later, washes the baby out with the bath water. I do not want to wash out the innocent and inadvertent with those who have proved they do not belong in the corporate community. That is why you have to watch that language carefully. And I would require a finding in some of the cases specified in the various subdivisions before drastic penalties could be imposed.

Senator Dodd. You would say "shall"?

Mr. Futter. No, "shall" does not go far enough. It only says "shall consider." That means they do not have to consider, that means they do not have to make a finding.

What I would require is a finding of the sort of conduct that you are talking about.

Senator Heinz. In each case?

Mr. Futter. Not in each case, Senator. That is why I said, I cannot do the language sitting here this morning. But I think, so far as fraudulent, manipulative, deceptive, you want a finding of some sort—and I am not spelling out all the words, obviously—of some sort of conduct like that.

This is the sort of conduct you are talking about, and I think that this is the type of conduct for which an applicant finding ought to be required before you can bar a man for life from office, or impose a penalty of $100,000 or $500,000 for a corporation.

Senator Heinz. With your permission, Mr. Chairman, could we ask Mr. Sporkin and Mr. Lynch what they think of this suggestion?

Mr. Sporkin. You see, Senator, while you were out for a minute I said that I think this is too harsh. I gave examples. When I was there, when you had do-nothing directors, a director that goes in and signs an undated letter of resignation and gives it to the chairman of the board, I think he has disqualified himself from later serving on another board.

Or, in another case, where you have directors who are getting large fees, that do nothing. So I do not think it is malfeasance; I think it is nonfeasance, as well.

Now, I agree that you should not fine these people a whole lot, but I still think that they ought to be out of the company.

The second thing I think you could deal with is, it should not be an absolute bar.

Senator **Heinz**. I was here when you said that. I remember all that.

Mr. **Sporkin**. So in other words, it would be something less than that.

Senator **Dodd**. What about this point?

Senator **Heinz**. What about requiring some appropriate level of findings?

Mr. **Sporkin**. You have to find that it is a violation, first of all.

Mr. **Futter**. But, Judge Sporkin, under this language, all you have to find is that it is a violation of any portion of this very complex statute, or any rule or regulation thereunder.

Tomes have been written on this statute. This statute is so complex that, when it goes up to the U.S. Supreme Court, you get a split opinion, and you may not even get a majority opinion.

Senator **Dodd**. I am enjoying this. I feel like the judge here. [Laughter.]

Senator **Heinz**. I am the judge. It is nearly noon, and I am sorry. I will rely on your good judgment.

Mr. **Sporkin**. I will let you try some of my drug cases, if you will let me. [Laughter.]

If you are going to make it so harsh, what you ought to do is to forget about the civil end of it and march them across the street, and indict them. To find what you need to put a director out of business, it is silly for the Commission to go through this. It should just put him in jail. He is then finished. He is not going to be a director any more.

It seems to me, we are talking about something that is less than where you are going to exercise the power to actually put the person away for 5 or 10 years in prison. So it seems to me that what you are talking about is the kind of thing that you have with a broker-dealer, except that you are not going to have the elaborate mechanism of qualifying directors.

You are going to do away with the first end of it. For example, now you have to qualify to be a broker-dealer, you have to meet certain qualifications. What I think this bill says, and what I think makes a lot of sense is that you are already in. But if you make a mistake, you can either go out forever, you can go out for a little bit of time, you can have a fine—and I agree that the Commission ought not to pile on. In other words, you ought not to try to just amass as much as you can against a person.

But I do think there is one thing that I did want to mention. Not only does there have to be a violation, but it always has to be in the public interest before the SEC can exercise its powers. And therefore, you have it that the Commission can be reversed for an abuse of discretion.

Senator **Dodd**. Gary Lynch.

STATEMENT OF GARY G. LYNCH, ESQ., OF THE LAW FIRM OF DAVIS, POLK & WARDWELL, NEW YORK, NY; FORMER DIRECTOR OF ENFORCEMENT, SECURITIES AND EXCHANGE COMMISSION

Mr. **Lynch**. Thank you, Chairman Dodd.

I am going to just briefly summarize my views, and answer any questions that you may have.

The enactment of S. 647 in my view would increase the effectiveness of the Commission's enforcement program. In particular, I think the Commission would benefit from the new penalty provisions, and from the provisions that authorize the SEC to bring administrative proceedings against officers, directors, and principal stockholders for section 16 violations, or failing to file forms 3 and 4.

I would note that, even though Chairman Breeden suggested some changes in S. 647 this morning, still under the revised Commission proposal the Commission would have the ability to bring administrative proceedings against people who violated the section 16 reporting requirements.

In my view, a civil penalty authority should generally be exercised in those cases involving deliberate fraud and manipulation, and in a limited range of other cases where there is a need to fill a gap in the current array of sanctions that are available to the Commission.

I think it is important for the Commission to maintain its historical focus on achieving remedial relief, rather than taking punitive action in every case, and that the Commission should still continue to judge the effectiveness of the Commission's enforcement program based on what it actually accomplishes, as opposed to what the dollar amount is that is ordered in a particular case.

My view is that the Commission should continue to pursue a very broad variety of cases, including those cases that do not involve conduct which is sufficiently serious or causes enough harm that one would really want to impose a penalty on anyone for the conduct.

The provisions of the bill which authorize the Commission to seek officer and director bars in civil injunctive actions and administrative proceedings are very controversial, as you have heard this morning. My view is that the Commission should be allowed to seek court orders barring an individual from serving as an officer or director in cases where that individual has engaged in egregious or repeated violations of the Federal securities laws, and in particular violations where that officer or director has in essence stolen the money from the shareholders, where they have enriched themselves at the expense of the shareholders.

I also believe, however, that it is unnecessary to give the Commission the ability to order an officer or director barred in administrative proceedings. And I am pleased to see, based on Chairman Breeden's statement this morning, that the Commission is no longer requesting that power.

I should add a concern that I have with regard to administrative proceedings, particularly the cease and desist power. I should qualify what I am about to say by noting that I really have had very little chance to look at Chairman Breeden's new proposal.

But I have some concerns about this temporary cease and desist power. If you really look at what the Commission is asking for, it is basically the authority to get an ex parte temporary restraining order. Perhaps that extraordinary authority is warranted in egregious cases where there is about to be huge harm caused to the public and it is clear that someone is engaging in fraud.

I am curious to see how the Commission actually requests this power in the proposed statute that they send to Congress. But if it is broad enough to allow the Commission to order a temporary cease and desist order without any hearing, in cases where there are complex accounting issues or where the Commission wants to say, "We are resolving the issue in our favor by the issuance of this order without a hearing," or to shut down a tender or exchange offer where there is a legitimate difference of views as to what the law requires, then I think the Commission's request for this authority may go a bit too far.

Senator DODD. That is a good point. We will look very carefully at it.

Mr. LYNCH. Finally, you asked me in the letter of invitation to comment on anything else that I thought was important for the Commission's enforcement program.

I think these additional penalty powers are for the public good. They should be given to the Commission. But I think Congress has to focus on the fact that without qualified people at the Commission to enforce even the current array of powers, the Commission's program over a period of time is going to become less effective.

Something has to be done to give the Commission the ability to attract and pay professionals, so that they can maintain the quality of staff they have had over the years. That clearly is the most pressing problem facing the Commission—not new powers, not new penalties.

Senator DODD. I agree with that. I just add that the Senators also fall under that category. [Laughter.]

Mr. SPORKIN. And judges. [Laughter.]

Senator DODD. We have already taken care of you, though.

Mr. LYNCH. Thank you.

[The complete prepared statement of Gary G. Lynch follows:]

WRITTEN STATEMENT OF GARY G. LYNCH, BEFORE THE SECURITIES SUBCOMMITTEE OF THE SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE REGARDING THE "SECURITIES ENFORCEMENT REMEDIES ACT OF 1989"

February 1, 1990

Mr. Chairman, Members of the Subcommittee:

INTRODUCTION

I am pleased to have the opportunity to appear before this Subcommittee to express my views regarding S.647, the "Securities Enforcement Remedies Act of 1989," and other issues relating to the Securities and Exchange Commission's Enforcement Program.

I am a partner of Davis Polk & Wardwell, a law firm with offices in New York, Washington, Paris, London and Tokyo. Prior to joining Davis Polk in September 1989, I was the Director of the Division of Enforcement of the Securities and Exchange Commission. My tenure as Director spanned the period from April 1985 until July 1989. My career at the Commission began in 1976, when I joined the Commission's Division of Enforcement as a staff attorney. I was promoted to Branch Chief in 1978, Assistant Director in 1981, and Associate Director in 1982, a position that I held until I became Director.

The views that I will present today are solely my own and do not necessarily reflect the views of other members of my law firm or my law firm's clients. It is only fair to note at the outset that I participated in the discussions and drafting process as various versions of the "Securities Enforcement Remedies Act of 1989" were being considered at the Commission. My views on the concepts embodied in S.647 evolved over my years at the Commission and were unquestionably influenced by my work experience in the Division of Enforcement, and in particular, my experience with the provisions of the Insider Trading Sanctions Act of 1984 ("ITSA"). ITSA, as the Subcommittee knows, gave the Commission the authority to seek civil money penalties for violations of the insider trading proscriptions. My support for the Act is thus based in large part on my experience at the Commission and my involvement in the Act's formulation, and to the extent that I must qualify my support for particular provisions, my reservations are similarly based on my experience at the Commission.

My testimony today will address the three major topics outlined by Chairman Dodd in his letter of invitation:

1. The need in general for additional SEC enforcement tools, and, in particular, the merits or problems associated with each of the new powers provided in

S.647;

2. Other enforcement issues which warrant the attention of the Committee, such as penny stock fraud and international fraud; and finally

3. What I believe will be the most significant enforcement issues confronting the Commission in the next decade.

SUMMARY OF VIEWS

My views can be briefly summarized as follows:

1. The enactment of S.647 would increase the effectiveness of the Commission's Enforcement Program and help insure the integrity of this country's capital markets. In particular, I believe that the work of the Commission will clearly benefit from the new civil penalty provisions, and from the provisions authorizing the SEC to bring administrative proceedings against officers, directors and principal stockholders for violations of the reporting provisions of Section 16(a) of the Securities Exchange Act of 1934 ("Exchange Act").

2. The civil penalty authority, however, should only be exercised in cases involving deliberate fraud or manipulation, or in a limited class of other cases where the assessment of a penalty would fill a gap in the current array of sanctions available to the Commission and thus add to the

deterrent function of the Commission's Enforcement Program. A civil money penalty should not become the sine qua non of all Commission enforcement actions. To put it another way, the Commission's historical focus on achieving remedial relief rather than taking punitive action should continue to provide the standard for evaluating the outcome of an enforcement action in most cases. Moreover, the Commission should continue to pursue a broad variety of enforcement cases, including those that do not involve conduct which rises to the level of seriousness or has caused sufficient harm to justify a harsh sanction such as a civil money penalty.

3. The provisions of the Bill which authorize the Commission to seek officer and director bars or suspensions in both civil injunctive actions and administrative proceedings are concededly controversial and should be carefully evaluated. I believe that the Commission should be allowed to seek, and federal courts should be allowed to impose, court orders barring an individual from serving as an officer or director of a reporting company when that individual has engaged in egregious or repeated violations of the federal securities laws, and in particular, violations which involve the enrichment of the violators at the expense of their corporations and shareholders. I also believe, however, that it is unnecessary and unwise to give the Commission the

ability to order an officer or director bar or suspension in administrative proceedings.

4. The internationalization of the United States securities markets will continue to pose difficult enforcement problems for the Commission in this decade. Congress can give the Commission the ability to cope more effectively with these problems by promptly moving to enact the "International Securities Enforcement Cooperation Act of 1989." In addition, penny stock fraud is also likely to continue to remain a serious problem, even with the Commission's increased focus on abuses in this market and its attempts to educate the investors who trade in penny stocks. Passage of S.647, however, will improve the Commission's ability to deal with this particular enforcement problem by adding to the Commission's existing arsenal of weapons against securities laws violations.

5. While the Act will be beneficial in many respects, the most pressing problem facing the Commission's Enforcement Program today is not the creation of additional penalties or powers. Rather, it is the problem of attracting and maintaining a staff of the consistently high quality that the Commission has maintained throughout its history at a time when the differential between salaries in the private sector and at the Commission continues to grow and when the

rapidly increasing workload of the Commission continues to necessitate an even larger staff. Expanding the Commission's arsenal of weapons will quickly become a meaningless exercise on Congress' part if there is no one at the SEC to use these weapons effectively.

AVAILABILITY OF CIVIL MONEY PENALTIES IN CIVIL AND ADMINISTRATIVE PROCEEDINGS

As the Subcommittee is well aware, the Commission has had great success in using its civil penalty authority in cases involving illegal insider trading under the provisions added by ITSA. By further expanding the Commission's ability to seek civil money penalties for other types of violations of the federal securities laws, particularly those involving deliberate fraud or manipulation, S.647 would give the Commission the ability to exact a cost that fits the violation and better deter that violator and others from engaging in similar conduct in the future.

In particular, as pointed out by the Commission and other supporters of this legislation, the addition of the penalties to the Commission's enforcement arsenal would serve at least four important purposes.

The Crafting of Appropriate Remedies

Having the option of imposing or seeking money penalties would give the courts and the Commission greater flexibility to tailor a remedy to the gravity of the violation. For example, under the current law pertaining to administrative proceedings, the Commission only has the ability to censure, place limitations on the activities of, or suspend or revoke the registration of, a broker-dealer, if the broker-dealer violates the securities laws or fails to supervise an employee who violates the law. If one branch office or one department of a large multiservice firm commits a relatively serious violation of the law, it might be difficult under the current law, depending on the facts and circumstances of the case, to fix a remedy that is appropriate. A censure may be too light a sanction given the conduct, but suspending the registration of the entire firm for even one day would have a draconian effect on that firm's operations, and confuse and harm customers. With the proposed fining power, however, the Commission could order a penalty that was appropriate under the circumstances, without having to forbear from taking meaningful action or to resort to crippling action. In addition, there are other types of violations which often do not involve egregious conduct but which cannot be remedied effectively by any of the current enforcement weapons available to the Commission. Violations of the reporting requirements of Section 16(a) of the Exchange Act fall into this category.

There are other cases where the most severe civil sanctions currently available are simply insufficient to adequately redress the violation and deter others. The violations which could be more effectively attacked with civil penalty authority include certain types of fraudulent and manipulative schemes which cause at least as much if not more harm to investors as insider trading violations. Without attempting to set forth an exhaustive list of the types of misconduct warranting fines, penny stock manipulations, ponzi schemes, and deliberate fraud and theft by individuals associated with investment advisors and broker-dealers are a few of the types of violations that would certainly warrant the exercise of civil penalty authority.

Finally, there are cases where the exercise of civil penalty authority would be preferable to any other currently available enforcement remedy, including criminal prosecution. These are cases where the facts and circumstances of the violation present a marginal case for criminal prosecution, but the defendants and others similarly situated will be adequately deterred by the imposition of large civil fines and thus imprisonment is not necessary or appropriate. In such cases, the Commission's or the courts' ability to assess appropriate civil money penalties would obviate the need for lengthy criminal proceedings, and free the resources of the Department of Justice to pursue cases more worthy of criminal prosecution.

Deterrence of Violators

The second purpose to be served by the addition of civil money penalties to the Commission's arsenal of enforcement weapons is deterrence. Hopefully, the spectre of civil money penalties will deter those who are tempted to commit securities law violations for financial gain by altering the economic consequences of the violations. By increasing the costs of engaging in certain lucrative securities fraud schemes such as penny stock fraud, money penalties will provide a financial disincentive to commit securities law violations that otherwise would result in large financial returns to the violator. The Commission's successes in the insider trading cases demonstrate that money penalties can be a powerful deterrent against what would otherwise be lucrative securities law violations, and I am confident that expanding the availability of money penalties to cover other types of securities law violations will prove equally effective.

Dealing More Effectively With Recidivists

Third, money penalties would help the Commission deal somewhat more effectively with the recidivist violator, who is willing to violate the securities laws in spite of the prior imposition of other sanctions against him for the same or similar conduct. However, it should be noted that for some recidivists, the hard-core fraud artists, criminal prosecution and imprisonment may be the only measure that will convince them to abandon their chosen profession.

Recoupment of Enforcement Costs

Finally, civil money penalties would enable the federal government to recoup some of the funds spent in enforcing the federal securities laws. As the Supreme Court observed in the recent Halper case, assessing fines for the purpose of recovering government costs associated with the enforcement of federal laws is a permissible use of civil fining authority. United States v. Halper, 109 S. Ct. 1892, 1900-02 (1989). Accordingly, in cases where the Commission seeks or imposes civil money penalties, one of the tasks facing the court, the administrative law judge, or the Commission should be to assess the costs of enforcement, so that the amount of the penalty is not based solely on its value as a punitive measure.

RESERVATIONS

While I am in favor of adding civil money penalties to the Commission's arsenal of enforcement remedies in order to achieve the aforementioned goals, I cannot recommend enactment of the new penalty provisions without first expressing a few misgivings. First, as I stated in my introduction, a civil money penalty should not become the sine qua non of all Commission enforcement actions. The sanction of money penalties should be reserved for violations involving deliberate fraud or manipulation, or for a limited class of other cases where the assessment of a penalty would fill a gap in the current array of sanctions available to the Commission and thus add to the deterrent function of the Commission's Enforcement Program.

Second, on a related point, the Commission should carefully examine whether those who ultimately have to pay the fine actually deserve to suffer a penalty. The Commission itself, for example, in its Memorandum accompanying its initial legislative proposal, emphasized that in cases involving corporate issuers, penalties "will be imposed or sought only where the violation resulted in an improper benefit to shareholders." Memorandum of the Securities and Exchange Commission in Support of the Securities Law Enforcement Remedies Act of 1989, at 5. As the Commission correctly recognized, it would be "inequitable" to assess a penalty against a corporate issuer in cases where the shareholders themselves have been victimized by the securities violations, given that such penalties are ultimately paid by the shareholders themselves. Id. at 4. Similarly, the Commission also noted that it "would not ordinarily seek penalties against registered investment companies," and that the Commission instead would assess fines against the investment advisors who manage the assets of registered investment companies that violate the Investment Company Act. Id.

The third point I would like to make is that the Commission must not abandon (or be perceived as having abandoned) traditional subjects of the enforcement program such as issuer disclosure violations, variances from Generally Accepted Accounting Principles, and broker-dealer, investment advisor, and investment company violations not involving fraud or manipulation, in order to pursue cases in which money penalties are warranted. Civil injunctive actions and administrative proceedings directed at violators who have made mistakes but have not deliberately defrauded others have served as important warnings to those persons who might be willing to play it close to the line separating permissible from impermissible activity. In addition, traditional enforcement actions have served as valuable tools for educating participants in the capital markets, as well as reminding them of their obligations under the securities laws.

If the thrust of the Commission's Enforcement

Program were to shift towards only those cases warranting the imposition of a fine, I believe that the result would be an overall watering down of incentives to comply with the securities laws. Given the ever-increasing number of filings with the SEC, and the growing number of investment companies, investment advisors and broker-dealers, the Commission currently relies to a great extent on the willingness of the private sector to comply voluntarily with the federal securities laws. In cases where entities or individuals go astray, but not so far astray as to warrant the imposition of a money penalty, the Commission should be there to fulfill its traditional policing role through the application of traditional enforcement remedies.

Finally, in the context of seeking civil money penalties against violators of the securities laws, the Commission has to take into account the effect of the Supreme Court's decisions in Tull v. United States, 481 U.S. 412 (1987), and United States v. Halper, 109 S. Ct. 1892 (1989). The Tull case, for example, will have a direct impact on the Commission's costs of litigation once the new civil money penalties are enacted. In Tull, the Supreme Court held that the Seventh Amendment guarantees an individual the right to a jury trial in civil cases where the government seeks a monetary penalty in the courts. 481 U.S. at 425. The jury trial requirement will certainly increase the cost and time associated with bringing civil actions in federal court.

In addition, it is reasonable to assume that as the Commission utilizes its penalty authority, more defendants and respondents will determine to litigate with the Commission rather than settle the case, if a settlement entails the payment of a large penalty. If the number of cases in litigation materially increases, there will be fewer staff members available to conduct investigations and thus the Commission's investigative "coverage" of the securities markets will decrease unless Congress provides sufficient funds to hire additional lawyers, accountants, and analysts to make up for those diverted to a larger litigation workload.

The effects of the recent Halper decision must be considered as well. After the Supreme Court's recent decision in Halper, it is now also possible that the imposition of a stiff monetary penalty could preclude a subsequent criminal prosecution in the same matter. See 109 S. Ct. at 1901-02 (civil penalties can constitute punishment for double jeopardy purposes when sanction serves punitive rather than remedial purpose). Accordingly, because of all these considerations, I believe that the Commission will have to think long and hard about the kinds of cases which might warrant the imposition of money penalties. The potential negative consequences of bringing such actions are also an additional reason for the Commission to use these new enforcement weapons sparingly, if Congress determines to give them to the Commission.

ADDITION OF VIOLATIONS OF SECTION 16(a) TO BASES FOR SECTION 15(c)(4) PROCEEDINGS

I strongly support the addition of Section 16(a) of the Exchange Act to the list of violations which may currently be the subject of an administrative proceeding under Section 15(c)(4) of the Exchange Act. Violations of Section 16(a), which imposes stock ownership reporting requirements on persons owning more than ten percent of any class of equity security registered pursuant to Section 12 of the Exchange Act and on the officers and directors of issuers of such securities, seldom rise to the level of seriousness required to bring an injunctive action in federal district court. Yet at the same time, violations of this provision thwart the purposes underlying the reporting requirements. The current inattention paid to Section 16(a) by some stockholders and officers and directors of issuers could easily and effectively be corrected by giving the Commission the authority to institute administrative proceedings against violators.

THE AUTHORITY TO SUSPEND OR BAR CORPORATE OFFICERS AND DIRECTORS

The power to bar or suspend individuals who have violated the federal securities laws from serving as officers and directors of reporting companies should be expressly given to the federal courts. But, this extraordinary relief should be reserved for those cases where an officer or director has demonstrated through egregious violative conduct the proclivity to misuse the trust placed in him or her by the shareholders of a reporting company. In short, this remedy should only be sought in cases involving deliberate fraud by the officer or director, and in particular in those cases where the officer or director has enriched him or herself at the expense of the corporation and its shareholders.

At this point in time, there simply is no need to give the Commission the broad power to order an officer or director bar in an administrative proceeding. If misconduct is egregious enough to warrant a bar, the bar should be sought only with an accompanying injunction against further violations and the recovery of illegally-made monies. These remedies can only be ordered by a federal court. In addition, if a defendant defies an injunction or disobeys a bar order, the Commission can then pursue a criminal contempt action, an alternative that would not be available if the bar were ordered in an administrative proceeding.

OTHER ENFORCEMENT ISSUES

While it is difficult to forecast the events of the 1990's which will demand the SEC's attention, one can say with near certainty that the internationalization of the United States securities markets will continue to test the SEC's ability to enforce the federal securities laws. The internationalization of the world's securities markets is a beneficial development for United States companies and investors, but this phenomenon has made it more difficult for the Commission to investigate many apparent violations because of the increased need to gather information which is outside United States borders.

The Commission has met this challenge through a variety of means, the most important of which has been the negotiation of cooperation accords with its counterparts in other countries. On December 14, 1989, for example, the Commission entered into an Administrative Agreement with the Commission des Operations de Bourse in France ("C.O.B."), wherein the SEC and the COB each agreed to assist the other in securities enforcement matters by: (a) providing access to information in their respective files, (b) taking the evidence of persons; and (c) obtaining documents from persons. In addition, the Commission entered into an Agreement on December 11, 1989 with the Ministry of Finance of the

Netherlands similarly designed to foster the exchange of information in securities matters. Both accords are broad, far-reaching agreements that should make it significantly easier for the Commission to obtain information in those countries which is relevant to a Commission investigation.

These agreements complement earlier accords with the securities commissions in the provinces of Quebec, Ontario and British Columbia in Canada, with the Brazilian Securities Commission, and less ambitious understandings with the United Kingdom's Department of Trade and Industry and the Japanese Ministry of Finance. In addition, the Commission continues to actively engage in on-going discussions with its counterparts throughout the world about the need for increased cooperation, and the growing problems posed by the internationalization of the world's securities markets.

To facilitate further international securities cooperation, and to trigger the implementation of the Agreement between the Commission and the C.O.B., Congress should promptly enact the the "International Securities Enforcement Cooperation Act of 1989." Both the Senate and the House of Representatives have passed this Act (S.1712 on November 16, 1989 and H.R.1396 on September 25, 1989) but because the Senate bill included other legislation which has not been passed by the House of Representatives, the Act has not been enacted. I urge this Subcommittee to take action promptly so that the "International Securities Enforcement Cooperation Act of 1989" will become law. Without this legislation in place, the Commission cannot be expected to meet the challenges that lie ahead in the area of international enforcement.

Penny stock fraud will no doubt remain a problem in the early part of the decade, if not beyond. The Commission's increased focus on the abuses in this market, and at least as importantly, its attempts to educate investors who trade in penny stocks, may help alleviate this problem. With the enactment of S.647, I believe that the Commission will have the technical enforcement remedies that it needs to begin addressing these issues. What this and other legislation fails to address, however, is the most important enforcement problem facing the Commission today--the growing difficulty in attracting the quality and quantity of professionals to effectively utilize the remedies given to the SEC by Congress.

THE MOST PRESSING ENFORCEMENT PROBLEM FACING THE COMMISSION TODAY

While the proposed legislation being considered today will undoubtedly benefit the Commission's work, the most pressing problem facing the Commission's Enforcement

Program today is not the creation of additional penalties or other legislation to enhance its authority. Rather, it is the problem of attracting and maintaining a staff of the consistently high quality that it has maintained through its fifty-six year history at a time when the disparity between salaries in the private and public sector has continued to grow, and when the ever-increasing workload of the Commission has necessitated the hiring of its largest staff ever. At present, the Commission lacks the resources it needs to detect and remedy securities law violations in the most efficacious manner. All of those who would like to see the securities laws vigorously enforced should work together to see that the Commission receives sufficient funds to do its work. Expanding the Commission's arsenal of weapons will quickly become a meaningless exercise, if the Commission lacks the resources it needs to utilize those weapons.

CONCLUSION

For the foregoing reasons, I support most of the provisions of S.647, and believe that the proposed enforcement remedies will enhance the Commission's ability to enforce the federal securities laws.

It has been an honor to appear before this Subcommittee today, and I appreciate the opportunity to express my views on these important issues.

Senator **Dodd**. Mr. Futter, we thank you for all of your patience. You have heard all of the things, and now you have a chance to respond to all of these suggestions.

STATEMENT OF VICTOR FUTTER, ESQ., OF THE LAW FIRM OF SILLS, CUMMIS, ZUCHERMAN, RADIN, TICHMAN, EPSTEIN & GROSS, NEW YORK, NY REPRESENTING THE AMERICAN SOCIETY OF CORPORATE SECRETARIES

Mr. **Futter**. Thank you, Mr. Chairman, Senator Riegle.

You were so kind in your introductory words before to express concern about my being outnumbered that I was going to suggest in my introduction that rather than saying, as everybody else who comes before you does, how pleased I am to be here and what a wonderful opportunity it is, that I would wait before saying that to see what happened.

As you know, I am appearing here today on behalf of the American Society of Corporate Secretaries, which has some 3,200 members, composed of some 2,400 corporations. That society strongly supports the objectives of S. 647.

We believe that corporate malefactors should be banned from service at the director and officer level, and should be subject to significant penalties, subject, however, to the comments which follow.

We have as little sympathy as the proponents of the bill for those who commit fraud, engage in market manipulation, or issue false and misleading information.

Linda Feinberg of the SEC was kind enough to call me late yesterday afternoon to tell me about the changes which Commissioner Breeden was going to propose this morning. Unfortunately, I was out of the office, and did not get back to her until later in the day, just as I was leaving. I really did not have the opportunity to study the changes which the SEC now proposes and accordingly I will not comment on them.

But a great deal of what the Commissioner proposed this morning goes to meet some of the comments which I will make now, and we applaud the advances which the Commission has made in those directions.

Where we part company from the proposed legislation is, as I noted earlier, that while we have been talking this morning almost constantly about malefactors, people who commit fraud, people who commit serious and knowing violations of the securities laws, or people who are recidivists, unfortunately, the language of the bill is not restricted to such persons.

The proposed bill would permit the courts and the SEC to bar a corporate director or officer from holding such office for life, the equivalent of an economic death penalty. It would also impose very substantial monetary penalties for any—and that is the word of the statute—for any violation of either of the Federal securities acts, or any regulation or rule thereof.

Senator **Dodd**. Let me interrupt you, if I can, right there. You have heard Judge Sporkin make the suggestion that there ought to be some sort of variation of this bar. And I presume that is what you are suggesting?

Mr. **Futter**. I would certainly suggest that, yes.

Senator **Dodd**. Number two, you heard Chairman Breeden talk about the tiering. I asked him—in fact, I quoted your testimony on that. That is something you would support as well?

Mr. **Futter**. Yes. Indeed, in my written testimony, which you have, there is a reference to an earlier letter submitted by the Securities Law Committee of the American Society of Corporate Secretaries which proposes just that. Thank you very much, sir.

The difficulty, as I said, is that we do not have a bill limited to those things. One would have thought that before imposing such drastic penalties as this bill does, that at a minimum, it would have required criminal conduct to be involved.

One looks in vain for the term "criminal conduct." And failing that, one would have thought there would have been a requirement for some sort of egregious, willful misconduct, like fraud or its equivalent.

I think Commissioner Breeden came a long way toward that this morning. But none of these are required, as the bill is presently drafted, for the imposition of the penalties suggested.

Under proposed section 21(D)(c)(1) of the 1934 act, the Commission may consider whether the act or omission involved fraud, deceit, manipulation, or deliberate or reckless misconduct. The language, "may consider," clearly denotes that the Commission may impose the penalty, whether or not there is fraud or deceit.

We would urge you, as I said earlier, Mr. Chairman, to make fraud and deceit a requirement for imposing the sanctions, and similarly to review the other subsections of that statute to see how they should be worded so that they are effective criteria—so that they are more than just considered.

In addition, the factors listed in proposed 21(B)(c) do not appear to apply to the other sections of the bill. We would think that such factors, or their equivalent, should be required across the board. In other words, similar penalties may be imposed under the other sections; why aren't the same factors required for imposing those penalties?

As I mentioned earlier, consider the complex type of laws to which the proposed act applies. But giving agencies—or even courts—the broad power to impose such drastic penalties, it should be borne in mind, as you gentlemen know far better than I do, that issues may on occasion become politicized. And in such circumstances, such a broad grant of power as is here proposed may be abused.

This, too, argues for the need of careful delineation. We simply do not think that it would be appropriate in any instance of an unintentional violation of any such law, rule, or regulation to bar the violator from serving as a director or officer.

Judge Sporkin mentioned two examples. Those are really covered by the duty of due care. They are covered by the civil suits which can be brought against directors. And I can also tell you that they are covered by the knowledge of the director community. When word gets out that fellows have given in written resignations and they are not doing their duty, they are not going to serve on boards.

Mr. **Sporkin**. They can set up their own company.

Mr. **Futter**. Then, word trickles down to the community. It is out there.

From a remedial standpoint, all that is required in such circumstances is to get the attention of the violator. Imposition of a vocational death penalty in such a case is a graphic instance of the punishment not fitting the crime.

Commissioner Breeden was quoting the Mikado this morning, and saying that the punishment ought to fit the crime. Why, one must ask, does the SEC need the power to so drastically punish unintentional and inadvertent violations of the act?

In this connection, I would note too that our experience in connection with violations of 16(a) is that for the most part those are inadvertent, or involve technical violations.

Senator **Dodd**. That is 37 percent who fail to file on time, the Chairman quoted. I am beginning to wonder.

Mr. **Futter**. We were astounded when he quoted that percent. And I would like to get some further details on that.

In other words, of the 37 percent, how many are 1 day late, how many are 2 days late, how many are 6 months late?

But I have had experiences, believe me, Mr. Chairman, with people who I know are honestly trying to comply with the act, and were just aghast when they found out that they had not complied with the act. Why hadn't they complied with the act? Because somebody had told an assistant secretary to take care of it, somebody told an associate in his office to do it, and for one reason or another, it wasn't handled promptly.

Put it this way, Mr. Chairman, you are a very busy man, you have a lot of things going on. You take the position of a corporate officer, he has the same problems. He has been out of town, he has been away. He comes back from Indonesia, he has four vice presidents that want to see him. He has four shareholders, three bankers—the last thing that he does is to take care of his own affairs, as we as lawyers know.

Senator **Dodd**. I file my FEC reports on time. I had better.

Mr. **Futter**. But I just do not think that that sort of inadvertent violation is in the same class as fraud and manipulation.

Senator **Dodd**. I do not think there is any question of that.

Mr. **Futter**. That is why I think it should not have the same penalty.

It is of concern that the proposed legislation puts the Commission in an unfair bargaining position, by giving it the power to seek or impose sanctions that are far out of line with the alleged violation, unless we have some gradation in the fines which may be imposed and standards for such gradation.

And this is particularly important for thousands of smaller companies. The larger companies may have the resources to defend themselves. The smaller companies may be hard-put to do so.

So we suggest that criteria be adopted—as you said, Mr. Chairman—that the punishment fit the crime.

Senator **Dodd**. With respect to the 16(a) reports, I know I have got a lot of things to do. But I know also that if I do not file my FEC reports in a timely fashion, I am going to be in serious trouble. And there is no excuse that my secretary or whoever else forgot to do it.

And of course, going back a long time, that provision was designed to police insider trading activities. There is ample enough time, it seems to me. And failure to take it seriously is exactly the problem we are facing.

Mr. **FUTTER**. Mr. Chairman, I agree with you, and I certainly want to correct that.

The Society has written a book about it. But the Society has also been working with the SEC, as have others to propose different remedies for solving the 16(a) problem, and these are less drastic.

First of all, there has been a proposal to file an annual form 5. Second of all, there has been a proposal to put a statement in the proxy statement concerning the failure to file on time. All you have to do is get a director's attention, and that will solve the problem.

That is the major thrust of my remarks, but there are a couple of other smaller points I would like to bring to your attention too if I may. First is the broad and vague language of proposed section 21(B)(a)(2), sections 21(B)(b)(4), 21(B)(c)(5), and 21(B)(c)(6). These propose to impose the proposed penalties on a person who "was a cause" of another person's failure. And this is just unclear and unfair. I would at least modify "cause" with such words as "deliberate" or "intentional" or "primary."

Suppose, for example, a CEO tells a corporate secretary that he must take care of matter "X" today. As a result of that, the corporate secretary fails to file a form 3 or a form 4 as requested by the director. Are both the CEO and the corporate secretary "a cause"?

Suppose it is late in the day and I have my form 4 sitting on my desk, and I am planning to file it, and Mr. Chairman, you call me. I am so excited, because I have had a call from the Chairman that I run out of the office to go home and to tell my wife about it. And I forget to put that letter in the mail.

Senator **DODD**. You're in trouble.

Mr. **FUTTER**. I know I am in trouble, but I want to know if you are also in trouble. Are you a cause? I mean, these words "a cause," are just very broad. I know I am in trouble, but are you?

Second, we have similar difficulties with the language which is found in the phrase "failed reasonably to supervise," in proposed section 21(B)(4); particularly when one recognizes that events will be judged in the glare and the illumination of hindsight, so that actions overlooked in the pressure of daily concerns suddenly take on the character of obvious actions which any reasonable supervisor should have taken.

Any trial lawyer worth his salt would have a field day with this language: "Did you do this?" "Did you do that?" "Why didn't you do this?" "Why didn't you do that?"

Finally, I would call your attention to the Commission's memorandum—and by that, I mean the earlier one in support of its proposed legislation, which makes two statements, at pages 5 and 15, concerning the way it intends to limit and ameliorate the broad powers given to it.

I think this matter was picked up by Commissioner Breeden this morning, but I am not quite sure. But we are saying, that if those are the Commission's intentions, then let's put it in the legislation. Let's not let it just be part of the legislative history.

There are three reasons why being a part of the legislative history does not suffice. First, as you know, there are those today who are advocating that legislative history not be considered when courts review legislation. And that, for all we know, may come to pass. I do not favor that point of view, but it is a point of view.

Second, things get lost in the desuetude of legislative history.

And third, one adminstration may have an entirely different intention than another administration. So if what is to be the law, let's put it in the law.

I would conclude by saying that the corporate community is as eager as you are to rid itself of the few malefactors who give the entire corporate body such a bad name that we all are pictured as the antiheroes of "Dallas" and "Dynasty."

But let's not wash the baby out with the bath water. Let's walk before we run. Then, having sensibly addressed the situation, let's see if there is any need for broader legislation. Let's be sure the proposed legislation only covers the truly evildoers, and does not give a license and invitation to prosecutorial discretion to hunt the innocent and the inadvertent.

[The complete prepared statement of Victor Futter follows:]

WRITTEN STATEMENT OF
VICTOR FUTTER

RE: S.647

UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS

SECURITIES SUBCOMMITTEE

February 1, 1990

Mr. Chairman, Mr. Heinz, Members of the Committee:

My name is Victor Futter and I appear before you on behalf of the American Society of Corporate Secretaries on whose Board of Directors I serve. I might add that I spent most of my career at Allied Corporation (now Allied-Signal) from which I retired as Vice President and Secretary. I am now Of Counsel to Sills Cummis Zuckerman Radin Tischman Epstein & Gross, one of the largest law firms in New Jersey.

The American Society of Corporate Secretaries is a professional association whose membership is composed principally of corporate secretaries, assistant secretaries and other business executives involved in duties normally associated with the corporate secretarial function. The Society's 3,200 members, representing approximately 2,400 corporations in the United States and Canada, are involved in such matters as corporate governance, the regulation and trading of securities, proxy solicitation and other shareholder activities, and the administration of the office of corporate secretary.

The Society strongly supports the objectives of S.647, the proposed Securities Law Enforcement Remedies Act of 1989, and the companion House bill H.R. 975. We believe that corporate malefactors should be banned from service at the director and officer level and should be subject to significant penalties, subject, however, to the following comments. We have as little sympathy as the proponents of the bill for those who commit fraud, engage in market manipulation or issue false and misleading information.

Where we part company from the proposed legislation is that we think that, worthy as are its objectives, the language of the proposed legislation is much too broad. For the most part, I shall limit my comments to the Securities Acts on the assumption that the same comments would apply to the corresponding sections of the other acts covered in the bill. I shall also be addressing the bill from the viewpoint of corporate issuers (and their directors and officers) since such issuers form the predominant part of the Society's membership.

Sections 101, 102 and 202 would permit a court in its discretion to bar an officer or director from serving as such for life -- truly an economic "death penalty" - and to impose drastic monetary penalties - for "any" violation of the Securities Acts or any rule or regulation thereunder. Similarly, Section 203 would permit the Commission to impose a substantial monetary penalty for "any" violation of Section 12, 13, 14, 15(d) or 16(a) of The Securities Exchange Act of 1934 or any rule or regualtion thereunder and Section 201 would permit the Commission to impose the economic "death penalty" for failure to comply (or for causing a failure to comply) with Section 15(c)(4) or Section 16(a) of the Securities Exchange Act of 1934 or any rule or regulation thereunder.

One would have thought that before imposing such drastic penalties, the bill at a minimum would have required that criminal conduct be involved. But one looks in vain for the term "criminal conduct" in the proposed legislation. Failing that, one would think that there would at least be a requirement for some sort of egregious willful misconduct like fraud or its equivalent or that certainly scienter would be required. None of these are required for the imposition of the penalties described. True, proposed Section 21 B(b) in Section 203 uses the word "willfully", a word which the Commission's Memorandum (p.11) recognizes does not require intent to violate the law; but even if this were sufficient, the term "wilfully" does not apply to a violation of Section 101, 102, 201, 202 or proposed Section 21B(a) of Section 203. Among other things, it would not apply to a violation of Section 16(a).

More importantly if one looks at proposed Section 21B (c)(1) of the 1934 Act (p.9), one notes that the Commission in determining administrative penalties "may consider" whether the act or omission "involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement". The language "may consider" clearly denotes that the Commission may impose the penalty whether or not there is fraud or deceit. We would urge you to make fraud or deceit and the other factors listed in proposed Section 21 B(c) a requirement for imposing the type of sanctions proposed. The factors listed in 21B(c)(1) do not appear to apply to the other sections of the bill. We think such factors or their equivalent should be required before imposing the sanctions of proposed Sections 101, 102, 201, 202 and proposed Section 21B(a) of Section 203. There is no reason for differing requirements when the penalties are essentially the same.

The Commission in seeking this legislation acts as though it will never have another bite of the apple, but we all know that the Commission can - and does - come back to Congress regularly. Let us therefore enact a properly narrowed bill to cover the evils to be remedied. After that has had a chance to work, let us see whether any broader powers are needed.

Further consider the type of laws for which the proposed act would impose drastic penalties for "any" violation of the statutes in question or "any" regulation or rule thereunder. The federal securities laws are among the most complex of our laws - surpassed, perhaps, only by the Internal Revenue Code. Tomes have been written about the complexity of its various sections; cases which go to the United States Supreme Court are decided by split vote and sometimes there may not even be a prevailing opinion on a particular point of law. Securities lawyers, as you well know, make a fortune interpreting this very complex statute and its expansive body of regulations. Do you really mean to empower a beauracracy or even a court to impose the severe penalty of barring a person for life from his or her principal means of livelihood for "any" violation of "any" regulation or rule under such a law? Such a penalty is close to a "cruel and unusual punishment" - and is certainly an economic "death penalty". To carry this to the extreme, do you want such penalties imposed for inadvertently filing a Form 3 or a Form 4 tardily?

If the Commission has the power to impose such penalties administratively, why should it ever seek court action?

In giving agencies or even courts as broad power and as drastic a remedy as can be imposed under the proposed legislation, it should be borne in mind that issues often become politicized and a power intended for use under more normal circumstances is used for political purposes. Hence the need for precise delineation.

Furthermore, in no conceivable instance of an unintentional violation of any such law, rule or regulation would it be appropriate to bar the violator from serving as a director or officer. From a remedial standpoint, all that is required in such a circumstance is to get the attention of the violator, and imposition of a vocational "death penalty" in such a case would simply not be appropriate. Why, one would ask, does the S.E.C. need the power to so drastically punish unintentional and inadvertent violations of the Act? In this connection, I would note that the Society's experience is that most violations of Section 16(a) are inadvertent or involve technical failures to comply. We think Section 16(a) should be totally excluded from the bill and addressed by other means which we or others have suggested such as the filing of an annual Form 5 or a description of failures to file in the issuer's proxy statement. We think this sort of deterrent for this type of offense should be sufficient. This is not in the same class of offense as fraud, deceit or manipulation and inclusion of Section 16(a) seems to have been dragged into the bill by the back door.

Despite the foregoing, I should note that the Securities Law Committee of the American Society of Corporate Secretaries is on record as not being opposed to the use of _properly_ _determined_ _fines_ in _specifically_ _restricted_ _circumstances_ to encourage compliance with the securities laws. In its letter of June 10, 1988, to Senator Proxmire commenting on S. 1323 introduced in the last Congess, the Committee acknowledged that "inclusion of provisions for fines in the statutory framework might be viewed as a step in the direction of motivating greater compliance with the filing requirements" [of Section 16(a)]. At that time the Committee recommended the following:

1. Any schedule of fines should probably be nominal since the fact of the fine and the attendant publicity would probably be sufficient to gain the attention of delinquent directors and officers.
2. The size of the fines might be graduated to reflect the frequency of offense.
3. There should be reasonable grace periods to account for travel and illness.
4. If fines were scaled to increase per day or per offense, there should be a maximum or cut off reasonably related to the size of the transaction.
5. If fines were scaled, they should be minimal in cases of innocent, inadvertent violation, given the considerable complexity of the rules.
6. Exemptions should be provided for transactions which do not involve true purchases and sales (such as gifts and benefit plan transactions); the potential for abuse is not present and the information is irrelevant to the market.
7. The structure and time limits applicable should be such as not to require the use of courier services, personal delivery or other expensive means of filing simply in order to avoid the payment of a fine.

8. Due process can be denied if the processes of both enforcement and appeal are too expensive. The SEC staff simply cannot afford to divert valuable resources in time-consuming procedures to collect fines. On the other hand, individuals need the opportunity to defend without being saddled with a procedure more expensive than the fine at issue. Whatever the regulatory and judicial procedures involved, there should be provision for appearances and appeals "on affidavit" and papers.

The difficulty with penalties as large as $100,000 and $500,000 are that they are so large that innocent persons or persons guilty of minor violations will be forced to defend against them. The very cost of a defense (which may not be indemnifiable, or if so, is paid by innocent shareholders), with legal fees being as expensive as they are, would be an unfair punishment. We would urge that the maximum proposed penalties be subtantially reduced, that fines be legislatively fitted to the offense and that for inadvertent or technical violations, the fine be minimal. In such cases only an eye catcher and a deterrent is needed. In this connection we would call your attention to the fact that a number of criminal statutes only carry a maximum penalty of $10,000. If the $100,000 and $500,000 fines are retained, they should be restricted to the serious violations: fraud, deceit, false public statements, market manipulation.

It is of concern that the proposed legislation puts the Commission in an unfair bargaining position by giving it the power to seek or impose sanctions that are far out of line with the alleged violation. In our opinion, the legislation should define with some specificity the circumstances in which the sanctions may be imposed.

We suggest that the legislation include many more criteria relating the scope of the penalty to the seriousness of the infraction, and that the power of the Commission to obtain significant monetary or other penalties be limited to circumstances where, among other things, scienter is involved.

This constitutes the major thrust of my statement, but I would respectfully and briefly call the Committee's attention to the following:

1. The broad and vague language of proposed Section 21B (a)(2), Section 21B (b)(4) and 21B (c)(5) and (6). To impose the proposed penalties on a person who "was a cause" of another person's failure is unclear and unfair without at least modifying "cause" with words such as "deliberate" or "intentional" and "primary". Suppose, for example that a C.E.O. tells a Corporation Secretary that he must take care of matter "X" today, and that as a result the Corporate Secretary fails to file a Form 3 or Form 4 as requested by a director. Are both the C.E.O. and the Corporate Secretary "a cause"? Suppose a director's secretary fails to mail in a Form 3 or 4, is he (or she) "a" cause? Suppose I keep you on the telephone, that as the result of that you rush for your train and fail to mail your Form 4, am I "a" cause?

Similar difficulties abound in the phrase "failed reasonably to supervise" in proposed Section 21 B(b)(4), particularly when one recognizes that events will be judged in the glare and illumination of hindsight so that actions overlooked in the pressure of daily concern suddenly take on the character of obvious actions any reasonable supervisor should have taken. Any trial lawyer worth his salt would have a field day asking "Did you do this?" "Did you do that?", etc.

2. The Commission's Memorandum in support of the proposed legislation states:

> "Given the wide variety of possible factual situations, the Commission believes that the proposed civil money penalty should be applicable to issuers, but that it should be imposed or sought only where the violation resulted in an improper benefit to shareholders. The Commission would consider this factor and also the extent to which the passage of time has resulted in shareholder turnover." (p. 5)
>
> "The Commission expects to follow its current policy of employing this remedy [the economic "death penalty"] only in cases involving repeat violation of the securities laws or involving egregious conduct as a corporate official." (p. 15)

These intentions should be explicitly embodied in the proposed legislation so that they do not fall into the desuetude of obscure legislative history under a different Administration.

The Securities Law Committee of the American Society of Corporate Secretaries stands ready to assist in the redrafting of the proposed legislation. That Committee, I understand, is preparing and will be submitting to you shortly a comment letter on the proposed legislation.

The corporate community is as eager as you are to rid itself of the few malefactors who give the entire corporate body a bad name so that we are all pictured as the anti-heroes of "Dallas" and "Dynasty". But let's not wash the baby out with the bath water. Let's walk before we run and then having sensibly addressed the situation, let's see if there is any need for any broader legislation. Let's be sure that we only cover the truly evil doers and not give a license and invitation to prosecutorial discretion to hunt the innocent or the inadvertent.

Senator DODD. Thank you very much. We appreciate your testimony.

Let me ask you, Judge Sporkin, and you, Mr. Lynch, a question I addressed to Mr. Breeden. In fact, I quoted you, Judge Sporkin, on the point.

You described this notion that we ought to have some sort of an international overseer due to the globalization of markets. Chairman Riegle has certainly talked about that for a couple of years, and has put in various pieces of legislation to move in that direction.

On the other side of it, of course, there is, to use your words, a "balkanization," a supermarket of regulatory hurdles. We mentioned the SEC, the CFTC, the Justice Department, among others, State regulators, and so forth.

Could you comment on that point, and this whole question that he raised about the exclusivity issue with respect to futures? I just think it is a major question. You are here, and I want to take advantage of your expertise, because it is a jurisdictional question, too.

Mr. SPORKIN. As you know, I gave a talk a couple of months ago——

Senator DODD. And we will put those speeches in the record with your prepared statement.

Mr. SPORKIN. The concern that I have is the one that you expressed. We are in a technological revolution beyond any imagination. That little microchip, if you realize it, is what caused the whole Eastern Block to come down. Information, that is what is really involved here.

Yet, everybody wants our market system; it is the best in the world. We have tremendous innovation from the business people who are way out in front. And we are now trying to regulate them, in terms of the 1933-34 world.

We have this tremendous overlay of regulation. The costs are ridiculous. Everybody under the sun is into this thing. You have got to modernize regulation, to make it the least intrusive possible. You have got to make sure the markets are honest, fair. And then, you have got to let the people get out there and play. And you have got to regulate them, but you regulate them with as few regulators as possible—and I would say you only need one, really.

Here is where the Chairman and I part company. He says that it is terrible to have only one agency regulating. That can be oppressive, but we have it with the Department of Justice in the criminal end; we have it with the FBI, it does all the investigative work. It can be done.

I think of course there has got to be oversight. But it seems to me that as we are going to get into the 21st century as we are going to work around this revolution, it seems to me that it has got to come. It might not come tomorrow—of course, the Berlin Wall came down faster than we ever thought—but I cannot for the life of me see why you need all this regulation.

It seems to me, you are going to have to have a group that is going to set standards. You are going to have to have the financial supermarket, it seems to me, and you are going to have to have one group that is going to enforce the regulations.

Then, we are prepared to go to the next step, which Chairman Riegle has mentioned and which I mentioned. You are going to have to have some international group that is going to be able to collect data, be able to set uniform standards and have a dispute resolution system. Because you are going to have this international aspect.

So I am looking into the 21st century, let alone looking into the 1990's. And the sooner we come to grips with this problem of overlapping regulation, the better off we will be. That you want to hold a hearing on this issue I think is tremendous. We seem to be putting all our effort into designing new products with the private system working around existing regulations, and making them collapse like they did with Glass-Steagall, instead of trying to say, what should be the form of the modern regulation that we ought to have.

That would avoid the problem that you are suggesting, where you have that exclusivity problem, which is mindless when you really look at it.

Senator DODD. As Chairman Breeden points out, you are dealing with one agency, initially. And you can end up with it being out of the jurisdiction of that agency, and in the other. How do you manage to track all of that?

Mr. Lynch, do you want to comment?

Mr. LYNCH. I would just pick up on a point that Chairman Breeden made. We are the only country in the world to develop markets where there is a different regulator for the securities markets than there is for the financial futures markets, the only country in the world where there is that situation.

It is clear that there is one market out there. And it seems relatively clear to me that regulations should follow what the actual world is, and it is one market.

Mr. SPORKIN. That was a fluke how that happened, by the way. What happened was, how you got this division, years ago there was a company out on the west coast called "Goldstein Samuelson." It started to market options and commodities. Nobody would take them on, except the SEC. We went after them under the securities law and took action against them.

Congress, as usual, said, "Look, this is terrible stuff. We must do something," Congress came to the SEC and said, "We want to give you jurisdiction to deal with these matters." We at the SEC said as we usually did—do not give it to us, give it to somebody else.

Now, the entity that was handling it at that time was a group over in the Agriculture Department that just really was not geared up to do it. So Congress said, "OK, you do not want to handle it, we are going to set up this new organization."

That is exactly what happened. If the SEC had stepped up and accepted what the Congress wanted it to do, we would not have had this.

Senator DODD. What year was that?

Mr. SPORKIN. It goes back to the mid-1970's, I would assume. It happened.

Senator DODD. How about you? We have heard a couple of old regulators here talking about overregulation. How do you react to that, Mr. Futter?

Mr. **Futter**. I do not know. I do not think I am really prepared to comment on that, Mr. Chairman.

There is one thing I would like to comment on, though, because Judge Sporkin made a statement which is on the record, and I do not think it should go without comment. He said that there are no qualifications required for serving as a director.

I would call your attention to several qualifications that are required for directors. First of all, section 7 or section 8 of the Clayton Act, states that you cannot serve on the boards of corporations which compete with another one. When I was an active corporate secretary, we had a book several inches thick listing the people who were disqualified because of conflicts under section 7 or 8.

Second, there are laws on the books which say, particularly in the communications industry, that you cannot serve as a director if you are an alien. There are other laws, both State and Federal, which go to other qualifications. In fairness I do not think Judge Sporkin was referring to such qualifications.

But generally the question of qualification is a matter of State law. That is a matter which is left to the States. This concerns the internal operation of a corporation—a matter of State law and is not a question for the Federal securities laws.

But beyond that, I would call to your attention the fact that many corporations have qualifications for their directors, written qualifications, adopted by their boards. The Society, for example, published a booklet last year which contained such qualifications.

Beyond that, I should note that boards are no different than your committees. Thus on a board nominating committee I have heard a director say of a proposed director: "You put him on that board, and I will not serve on the board." The word gets out in the community of directors just as it gets out in your community.

You know the people who are good, and you know the people who are no good. And that is why I say we support this legislation, because we want to get rid of the people who are no good.

Senator **Dodd**. Thank you, Mr. Futter.

Chairman Riegle.

Senator **Riegle**. Thank you, Mr. Chairman.

There are several things I want to get into. We had Secretary Brady up in the Budget Committee today presenting the money side of the budget proposal, with the President's items enumerated in the State of the Union address last night. So that necessitates the coming and going between committees.

I want to touch on several things. Chairman Breeden today proposed that officers and directors could only be barred from further service if they intentionally violated securities laws and a court, not the SEC, imposed the bar.

What do you think of this proposal?

Mr. **Sporkin**. Again, I think that cuts away from a lot of the objections that I heard. You have an independent, impartial forum, when you go to court. The only concern I have is, the intentional scienter violation requirement—and this is the point we are having a debate on.

If you have the kind of standard that is proposed by the SEC, it is a criminal standard—and I submit to you that when a person commits a crime and he is sentenced, the judge can bar him; so I do not think it is needed for that. I think you need it for something less than a criminal standard.

I cited two examples that I recall; namely, one where you had a board where every member of a major corporation signed an undated letter of resignation and handed it to the CEO, without telling anybody. So that CEO had the whole board. The public thought that they were dealing with an independent board; they were not. Those people should not be allowed to serve on another company's board. They do not meet the standard that the proposed modification of the legislation suggests.

Another cases we had, we had three directors, in which the directors did not do anything. And the SEC finally had to come out with a nasty release.

But it seems to me that you have got to deal with that problem. If you make it such a strong requirement, then you have got a criminal requirement. It seems to me, the SEC ought to just march those people across the street and proceed criminally.

But we have this terrible hurdle that seems to be hard to get across. We do not have any problem with suspending a broker, or putting him out for 6 months when he missteps. We do not have any problem with a banker when he missteps. Why should we have a problem with a director or officer of a major industrial concern that handles as much or more money than these other entities?

And what you have done, which I think is magnificent, is that you have not set up an elaborate regulatory scheme, where you would require certain qualifications to serve on a board of directors. At present, you do not even have to read or write to serve on a board. All you have to do is own some stock, and you can become a director.

What you have done is, you have proposed what I call regulation by exception. The "exception" is thrown out when he transgresses. So anybody can come in. And then the bad apple, the exception is disciplined. He need not be barred forever. It is the court that is going to impose this sanction. And courts I hope are not stupid. If somebody just missteps, the court will be able to impose an appropriate sanction against the offending person.

You can dress this up to say that it does not have to be a full bar. They could make it conditional, they could require that the person take a course somewhere. So I do not think it is a harsh penalty, and I think it is one that is absolutely necessary. Many, many years too late in coming.

Senator RIEGLE. I have got to leave, because they are holding my slot upstairs to cross-examine the Secretary, and I want to be sure to do that today. But there are two or three other things I want to get into.

In the past—and you have touched on this today in part, as I have heard—you have expressed some strong reservations about the concept of functional regulation in a deregulated market. There are a lot of people around with different views on this.

I would just like you to expand on that view. If that is your view, and you have got concerns about it, I really think we need to hear that.

Mr. SPORKIN. I think, briefly, as I answered Chairman Dodd's question, it is that we are into this dynamic age that we are in, that we have the private sector out-pacing the regulators, regulation has not been changed for 50 years. There is too much of it. There are too many regulators out there.

We have got to streamline it, because otherwise it is going to impede our great market system, the functioning of the system. Too much bureaucracy, too much regulation.

Senator RIEGLE. It seems to me, the other side of the debate is going exactly the opposite way, and that says that the answer here in this proliferation of activities is to continue to segment—and they have a functional regulation—all of this side-by-side activity.

And I guess what you are saying is that you think inherently that is an unsound concept.

Mr. SPORKIN. Well, if you are going to go to the financial supermarket, what we want to do is streamline the regulatory mechanism. The greatness of our country is allowing the private sector to have the initiative, not for the Government to tell them what to do.

It seems to me, you have got to allow that to happen. You have got to allow the financial supermarket to develop. That is an important thing.

In other words, you are going to separate the investment aspect of banking, from the money payment aspect. So you are going to treat all the investment aspects as one group, and therefore the regulation ought to be modernized to deal with that problem.

To add these tremendous costs of having to comply with the SEC, the four or five bank agencies, the Federal Trade Commission, the antitrust division, and then 50 States—if I were a businessman I would say, "Why go into businesses?" It drives you nuts.

Senator RIEGLE. If we have enough good people, properly paid so that we are getting top-tier talent, you think we can actually build a bureaucracy, financial supermarket, oversight agency that can keep track of all of the disparate parts, and keep track of all of the cross-connecting kinds of concerns and considerations and so forth?

You think we can in fact put all of that under one roof?

Mr. SPORKIN. Yes. I think you would do it well now. We do it well now, as I pointed out, in the criminal end of the Department of Justice. We have only one agency criminally prosecuting all violators. I think the Department of Justice does a pretty good job.

We had the same thing, in a micro way, at the SEC, when we had enforcement in each division. Then, the chairman came in and said, "This does not make sense," and he made it into one division.

That is the reason you have the finest enforcement agency in government today, because of that one thing that was done; because you then prioritize the entire enforcement program. Now, what did I do when I took it over? I still had specialists. I had my specialists in the 1940 act, specialists in the 1933 act. But I had to acquaint myself with all of the acts, to make sure that the program was performing effectively.

So what you will do is, you will have specialists who would report to a few good people, who could have a broad gauged ability to deal with the various financial market problem.

But the kind of thing that boggled my mind was, we would go into a broker-dealer, we would find one client there that was being churned in the securities area. But then, we could not look to see if this customer was also being churned in his commodity account, because commodities were outside our jurisdiction.

And that is what is going to happen. You cannot stop the financial supermarket. In other words, what you have got to do is to make sure that the private sector is being able to flourish, and that it is honest and fair. You are still going to have to have very strong standards and tough enforcement, but the private sector ought not to be hindered by all of these impediments that stifle its ingenuity.

I think, if you continue the way we are going now, costs are going to be prohibitive.

Senator **Riegle**. There are two to three things that I really want to nail down here in the time that I have.

Were you here when I was inquiring about the junk bond situation?

Mr. **Sporkin**. Yes.

Senator **Riegle**. I am very interested, from your vantage point, if you were running the SEC today—and I am not trying to second-guess anybody else—but bringing your experience to bear, when you look at the developments in the take-over market, leveraged buyouts and what has happened to junk bonds, the turmoil in the junk bond market where people could not get an accurate quote if you happen to be a small investor—how do you see these issues? How important are they? What do we need to be doing?

Mr. **Sporkin**. What concerns me, Senator—and I know I am preaching to the choir here—is that we all knew this was going to happen. This is not second-guessing. We were told by the economists that this was the greatest thing in the world. This collapse was not going to happen. You knew it was going to happen, I knew it was going to happen. I said it was going to happen.

So we ought not to be surprised. As it happened, there is nothing there. There is air. We were sold a bill of goods. And the point is that kind of thing clearly has to be dealt with. I think now the market has probably dealt with it.

But it seems to me that we should in the future prevent that from happening. Because while the greatness of the free market system is the free aspect of it, it is also its greatest threat. If you allow our markets to be totally unregulated, then you are going to destroy the system itself. It will just self-destruct.

Program trading is another problem area. We all know something amiss is going to happen, if somebody does not step in to do something.

Senator **Riegle**. What should we do about it?

Mr. **Sporkin**. The one thing about program trading that bothers me is, we do not have a definition of it nor do we know all the facts about it. Something that I have been suggesting, and something that you have been in favor of is the tremendous need to have a look at all this, to have a so-called special study. That is the first thing that has to be done.

That should not prevent steps being taken to deal with immediate problems. That is one of the criticisms I heard, that is, a special study means that we are going to put all these current problems on hold and not deal with them. That does not and should not be the case.

But what would a special study do? It would tell us a whole lot about these things. Now, I can come up with my suggestion right now, and I will mention what I think it is. But my problem is that I would like to know the facts as much as anybody.

Our primary markets are so vital to this Nation and its citizens that they ought to be as unimpeded as possible, and they ought to be stripped away from the so-called "barnacles," these other products that are trading off that market.

Why do I say that? I say it because virtually all our pension funds depend on our financial markets. Even the Government people now have their pension money in the stock market. Just think about an individual who is going to be cashed out on a particular day, which is the day the market drops 180 points. He is terribly disadvantaged for the rest of his life or her life.

What that means is, by having so much geared to the market prices, our primary markets must as much as possible reflect the underlying conditions in the economy. I am not saying that markets will not go up and down, they certainly will. But they should go up and down as conditions in the marketplace require or demand. They should not go up and down because somebody is out there playing with that market and is causing tremendous volatility. That to me is wrong.

How do you deal with it? Well, years ago when the 1934 act was written, somebody said, "There are certain kinds of trading that we find objectionable." Now, if you look at some of those trading methods that were outlawed, and you look at what is going on today, you are going to see some resemblances.

But Congress, to its credit, went and banned certain trading techniques. For example, such things as match orders and painting the tape, which were trades in which there was no change in beneficial ownership, were outlawed. In plain terms, people simply were manipulating the market.

Now, I sometimes wonder, or ask myself, if we did not have those provisions on the book today, could we get those provisions enacted? I am afraid we would be told, "They are great. They provide liquidity in the marketplace."

Therefore, if we could just step back and get the wisdom from the past, and look at some of this current trading that is objectionable and just ban it. One thing the Chairman mentioned today is also troubling and that is this activity is regulated by two different agencies.

Senator RIEGLE. Let me ask you this.

Some people would say, in response to that, "Well, suppose you do not do it? What are the real dangers?" Well, one of the dangers is, you create a bad market psychology, and you drive the small investor out, because the small investor realizes there is a certain rigged aspect of the game. And so they go to the sidelines.

Then, there is the question, well, how much does that damage capital formation, savings, fueling the engine of growth, and so forth? People come back and say, "Well, more and more of the serious stock trading is in the hands of institutional investors, and they are going to be in there anyway."

So if the little guy gets pushed out—and I happen to subscribe to that view although I find it offensive—they say, "Well, you have got the institutional investors coming in with large blocks of money. They are sophisticated," and so forth. So that you really have preserved the kind of rough equity and integrity in the system, because you have got big players that presumably are smart enough to go in and sort of deal with these elements of additional volatility and so forth.

How do you react to those arguments?

Mr. **Sporkin**. You have got to realize that this goes all the way back to Adolph Berle. These people that are running these funds do not have any personal interest in the funds they manage. They are not the investors. It is the pensioners, it is the little guy. It is his money that is being used all over the place.

The concern that I have is what I call the cop-out kind of suggestion; namely, that what we do is, let the big boys, or the big pension funds, just play there, and they will get some rough justice. But that will destroy our markets completely.

It would seem to me that we will be going to totally negotiated markets. Nobody will know what is going on. The figures in the paper will be wrong. How are we going to evaluate our investment company's portfolios. How are you going to have any real evaluation of anything? In my view we must keep our markets as pure, and as clean, and as honest as possible; keep the barnacles off the boat, or keep these derivative products away from the market and let it function.

Let's try it. I think it is going to work. I think it is going to work better than allowing all this volatility. People who want to use the computer to trade up and down and all over the place should do it somewhere else. Let them have their own marketplace in some gambling casino somewhere, but keep them away from the primary markets.

I think it can be done. I think that is what a study is going to come out with. You are going to get a lot of input. And I suggest to you, if you have a study, it has got to be a broad-based one, not only dealing with SEC matters, but dealing with all your financial matters, the entire banking and securities industry.

And I think therefore, if I can suggest it, it has got to be under some joint committee of the Congress. Congress has got to run it and oversee it. But it has got to happen.

We did it back 25 or 30 years ago when we had the special study. It was wonderful. But the problem there was, they were looking at internal matters, they were looking at how the securities markets themselves ran. Now, we have got all these external matters that are coming into play, globalization, internationalization, the fact that you have the supermarket concept. So we have got to really look at different issues.

Senator **Riegle**. Did you get into a discussion earlier while I was gone about the growth of leveraged buyouts, and the hollowing out of balance sheets, and debt replacing equity, and the whole question of who calls the tune in companies any more?

Was there any discussion on that?

Mr. **Sporkin**. There was not any discussion on that.

Senator **Riegle**. Are you as concerned about that as some of us are here?

Mr. **Sporkin**. Yes. Again, if you recall—and again, I have talked about this—again, we see what is happening. It was predicted. And it was predicted on the basis of ignoring what I and you and others have been saying, accepting what we were being told by certain groups, that this could never happen and was not going to happen.

Well, it did happen. And at this point, maybe they are right. Maybe the market will take care of it, but look at the cost, look at the carnage out there.

Senator **Riegle**. I am not sure we are through.

Mr. **Sporkin**. It is like telling me that we are going to deal with the problem of murders in the District of Columbia when everybody gets killed. That is the way we are going to deal with them. Just let everybody kill everybody else and there will not be anybody left, and there will not be any more murders.

I mean, so that is what you have got here. They are going to destroy the whole corporate community. Companies vital to our competitive market system, that ought to be competing are going out of business, not because they cannot compete, not because they are not putting out a good product, but because somebody has played around with the system.

Out on the pike—there used to be a store called "Bradlee's". Bradlee's is not there any more, not because they were not putting out a good product, but because somebody threatened to take them over. Then to ward off the threat, Bradlee's had to internalize and sell off many of their real estate properties.

Just look at the tremendous costs we put our companies through in this country just to fend off these things. Bloomingdales is another one now that cannot pay their bills—not because it was not making money, but because somebody decided it was going to take Bloomingdale's over and pay it back with its own money.

You know, this would be one thing if this was something new. This is nothing new. If you go back to any one of those real estate seminars, they were telling you how to use this gimmick of using somebody else's money to go out and buy real estate with no money down. We do not have any geniuses out there that have discovered a new technology. All they did is apply a known system to new areas.

Senator **Riegle**. It is several orders of magnitude higher. It was not a question of getting a house with no downpayment, it was basically getting a company or a major conglomerate.

I want to just ask you one other thing, and then I would like to give your colleagues here a chance to add anything that they wanted to.

There are several things I wanted to address directly to you. That is, you have had really an exceptional history not only as the director of the division of enforcement, but the former general counsel of the CIA. And you have thought a lot about what happens here, and how we fit into the world.

We are seeing enormous flows back and forth—and I am now talking about a global market situation—we are seeing an awful lot of investment taking place in the United States, foreign investors coming in.

Are there areas in your view—and I know this requires a personal judgment, and I ask you just to reflect on it—where foreign investment beyond a certain point in some sectors or some segments starts to pose a real concern with respect to national security? If so, what might that be?

Mr. **Sporkin**. In my view, I think you hit the ball.

I saw this going back to 1981. When I took over as general counsel at the CIA, I had no idea about matters of that kind. I did not know anything about the intelligence area at that time.

I was asked by the director, Mr. Casey, to come over there. One of the first and earliest things that came to my attention was that we were going to build a new building with a company that was owned or controlled by a foreign entity.

I went to the director and I said, "Is this right? They are going to know where all the installations are. They could in fact bug us; Bill, what do you think?" He said, "I did not know that." And nobody seemed to be concerned. And here, I am dealing with people with tremendous years of experience.

Well, Casey said, "It is going to end." And he said, "There has got to be an American company that can do it."

I kind of think that we have not really focused on this issue. We have got to realize, there are two things that are happening here. One thing is the takeover of companies that have a defense component. The other thing is that we are now sending so much of our work overseas, so much of our fabrication outside this country, that we might not be able to put together the tools of war that will be necessary to fight a war, if we ever need to.

Now of course, the sun is shining; therefore, who needs to fix the roof?

But it seems to me that is an area that we have got to be very concerned about. Somebody has got to look at the two aspects of the problem, to find whether we do have the capability in this country to build the tanks or do whatever else is needed without having to go to Japan or somewhere else. Because that would cause a horrendous problem.

Senator **Riegle**. How about financial services? Have you thought about that? Let me give you a couple of numbers. You may not have seen them.

Japanese banking in the United States is about 12 percent or so of the national total, and it is up to about 24 to 26 percent in California. You tend to see that. You see when foreign penetration comes in, you saw it with cars and trucks. You get a certain impact on the coast, and then it works across the country. But we have seen that in banking.

The financial services, the banking system, does that fall into the strategic category? Is it simply tanks and trucks?

Mr. **Sporkin**. In this area, I must say that I have not really thought about it.

I am obviously nervous. I am nervous because—well, I am nervous for two reasons. One, it does not sit right with what I know. And second, when I see people whom I sometimes do not have a whole lot of respect for tell me that it is good for the country, I am doubly nervous. They say it is the greatest thing in the world, so I become doubly nervous.

But I would certainly want to look at it much more, particularly when these other countries are not allowing us to do anything in their countries. There is no reciprocity, here.

Senator RIEGLE. In fact, the share of American banking activity in Japan has been going down. We got to the point where we were up to about 3 percent, and we have slid backward to about 1 percent. So you have got this odd anomaly, where their penetration here is growing very dramatically, and ours is receding there.

Mr. SPORKIN. I believe that we can do anything we want in this country. What concerns me more than anything else is that we seem to be taking a back seat to other countries. I cannot understand that, because we have the technology in this country. We have got the capital in this country. We have got everything in this country. And there is something that is not clicking.

We have got the system. The Japanese cannot come close to us, with the democratic system that we have here in this country, the way we elect officials. Yet, for some reason, we are just not clicking, and somebody has got to see where the problems are and see why it is that we cannot really compete any more.

Senator RIEGLE. One of the answers is, it relates to something we said a while ago. You have a concept of how we are going to view the way we regulate the financial system, in terms of something that is all encompassing.

If you look at what the Japanese have done with something like MITI, for example, where they have put together the concept of partnership and cross-connection and relationships, so that you think in terms of an efficient running of the whole, rather than getting sliced into so many parts and overlays—you lose efficiency. You may gain something else, but if you are in an international race where efficiency means something, and the gap is so wide that you slip out of first place into tenth place, you can have a real problem.

And it seems to me in a sense that they found some operational models. And one of the ways they do it is, they cheat in trade, as well. It is a double standard, in terms of selling elsewhere, and not allowing people really to sell there.

I just have to make one other observation. It does not directly relate to anything I have said here. But I am struck by your comments, in thinking about it. If you all read the story today about the opening of a "McDonald's" hamburger stand in Red Square, if you had been there, as I had the chance to be, the lines were longer yesterday in front of "McDonald's" in Red Square than they were at Lenin's tomb. I suspect it may stay that way.

But it is so interesting. You talk about the information revolution. In fact, once the world can tune in on what is going on somewhere else, whether it is blue jeans or music, books or ideas, or what-have-you, you know, the world is going to move in that direction.

Mr. SPORKIN. Again, I do not know if you had met Casey, but he had a tremendous insight as to what was going on.

It was a simple conclusion that Eastern Europe would one day declare its independence. With respect to many of us we shared common forefathers. These are bright, able people. But it was only a question of, when they got all the information, what they were going to do. They were not going to stand for it forever.

Nobody could predict the timing. That timing blew everybody's mind. But isn't it amazing how quickly it happened?

And what I say to you is, why does it take us all this time to solve our problems when we know what the solutions are?

Senator RIEGLE. The problem I think is partly hubris, it is partly "manifest destiny," it is partly sort of the John Wayne conception of ourselves in the broad sense. And that is that all we have to do is be Americans, and we get to stand up on the top step at the Olympics and get the gold medal, and it does not work that way.

And I think, you know, part of the problem is that the people who lost World War II got serious about coming back and reclaiming what they felt was their position in the relative scheme of things.

When you look at the problems that the Soviets have, which is really the failure of communism as a human system and as an economic system, and the financial exhaustion of the cold war, which they have taken on as we for the most part have—they have got their set of problems, we have got a different set of problems. But they are analogous in a different form, because we have got a certain kind of financial exhaustion that has sort of hit us, and a certain amount of hubris.

And I am so struck by the fact that the folks that lost World War II look awfully strong today. West Germany, albeit probably not now, at some point not too far down the track, absorbing the East Germans, is a pretty solid player. And Japan certainly does not have to stand second to anybody in terms of the way they are performing.

Mr. SPORKIN. They are not going to do it with junk bonds, either.

Senator RIEGLE. No, they are not. As a matter of fact, in Japan they raised five times the amount of equity capital than we managed to do in this country. To me, that is just an appalling statistic, and relates directly to what we are talking about.

How do you have capital markets that work, that have sufficient integrity and safeguards so that people can invest in their country and can invest in their own future with some sense that it is a fair game, it is a fair operation?

We have sort of engaged in conversation. Gary, do you have anything you want to add here for the good of the order, before I adjourn? And then I am going to ask Mr. Futter the same thing.

Mr. LYNCH. After that, I would have no idea where to start. [Laughter.]

Stanley was a difficult act to follow as director of enforcement, and he is equally difficult to follow before this subcommittee.

I guess I could talk about theories of the origins of the universe, and whether the common cold will ever be cured. This has been such a broad-ranging discussion, I have no idea where to drop into it?

If you want to steer me in a certain area, I will try.

Senator RIEGLE. Let me just ask you a sentence or two on functional regulation. Where do you come out in that debate?

Mr. **Lynch**. I support functional regulation. But if I understood Stanley correctly, he was saying that we needed one overarching agency who would take responsibility for all of financial regulation.

I am not certain that has to be done. I am not certain that is necessarily a part of functional regulation. I think when you were out of the room, I said it is important that there be the same regulator for the securities markets as there is for the financial futures markets, because it is one market.

And even if there were this one overarching agency, we would still have to have groups within the agency, I think, responsible for policing securities activities, and another group responsible for policing banking activities.

There are conflicts that will arise during the course of performing those two different functions. Could the conflicts be sorted out a little better in the same agency? Perhaps. But I think we have a long way to go before we get to that point. And there are other areas where we could at least combine agencies or combine different functions of agencies, to be a little more efficient in the regulatory process.

Senator **Riegle**. I know you had your hand up a couple of times, and I really am not so discourteous as to not have seen it. But I really wanted to cover some ground with Mr. Sporkin here. I am sure you understand that.

But let me give you a chance to add something here, before we adjourn.

Mr. **Futter**. It is just a postscript, sir. And it is with some hesitation that I add it, having listened to this high-level discussion, to bring us back to the nitty-gritty.

But if you will forgive me, there are two things that I just did want to get into the record. One, it has been suggested that some of us are saying that the penalties in the act should only be imposed in a criminal situation, and that really is not the position of either the Society or the other people I have listened to, at least at this end of the table.

We have suggested that the penalties be imposed for fraud on other serious violations. It is a long time since I have been in law school, but as I recall, in first year torts, we studied fraud, and that is a civil—not a criminal—act. Similarly the other acts we were talking about give rise to civil, not criminal, suits.

Second, with respect to the example which Judge Sporkin used, I would like to know what happened to those people after there was publicity about what they did. How many major boards and major companies did they serve on?

Third, I would suggest to you that most of those things would have to be disclosed in a proxy statement, if I remember my director's questionnaire correctly and its questions about prior acts and prior convictions.

Those are the thoughts I wanted to leave on the record. One other matter: I understand that the securities laws committee of the Society of Corporate Secretaries will be submitting comments to both the proposed legislation and the new proposals this morning.

With that, I thank you very much.

Mr. **Sporkin**. Thank you very much. I have nothing further.

Senator **Riegle**. We appreciate your being here. I am sorry that we had to be away for part of the discussion. I have to go back and try to pin the Treasury Secretary on the diluting of the Social Security Trust Fund. It is not an easy matter.

Thank you very much. The committee stands in recess.

[Whereupon, at 1 p.m., the hearing was adjourned.]

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE
GENERAL COUNSEL

February 9, 1990

The Honorable Christopher J. Dodd
Chairman
Subcommittee on Securities
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510-6075

Re: S. 647, the "Securities Remedies Enforcement Act of 1989"

Dear Chairman Dodd:

On behalf of Chairman Breeden, I am submitting a proposed revised version of S. 647, the "Securities Law Enforcement Remedies Act of 1989." This revision reflects the recommendations for changes to S. 647 set forth in the Commission's testimony that Chairman Breeden presented at the Subcommittee's hearing last week.

The Commission looks forward to working with you on this important legislation. You or your staff should feel free to contact me at 272-3171 if you have any questions concerning this legislation.

Sincerely,

Daniel L. Goelzer

Daniel L. Goelzer
General Counsel

Enclosure

(Similar letter sent to
the Honorable John Heinz)

cc: The Honorable Donald W. Riegle, Jr.
The Honorable Jake Garn

PROPOSED LEGISLATION

A BILL

To amend the federal securities laws in order to provide additional enforcement remedies for violations of those laws.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled.

SECTION 1. SHORT TITLE; TABLE OF CONTENTS; EFFECTIVE DATE.

(a) SHORT TITLE.--This Act may be cited as the "Securities Law Enforcement Remedies Act of 1990".

(b) TABLE OF CONTENTS.--

TITLE I--AMENDMENTS TO THE SECURITIES ACT OF 1933

Sec. 101. Authority of a court to impose money penalties and to prohibit persons from serving as officers and directors.
Sec. 102. Cease-and-desist authority.

TITLE II--AMENDMENTS TO THE SECURITIES EXCHANGE ACT OF 1934

Sec. 201. Enforcement of title.
Sec. 202. Civil remedies in administrative proceedings.
Sec. 203. Cease-and-desist authority.
Sec. 204. Conforming amendments to section 15B.

TITLE III--AMENDMENTS TO THE INVESTMENT COMPANY ACT OF 1940

Sec. 301. Civil Remedies in administrative proceedings.
Sec. 302. Money penalties in civil actions.

TITLE IV--AMENDMENTS TO THE INVESTMENT ADVISERS ACT OF 1940

Sec. 401. Civil Remedies in administrative proceedings.
Sec. 402. Money penalties in civil actions.
Sec. 403. Conforming amendment to section 214.

TITLE V--AMENDMENTS TO THE CRIMINAL CODE

Sec. 501. Grand jury secrecy.

(c) EFFECTIVE DATE.--The amendments made by this Act shall apply to any conduct occurring after the date of enactment of this Act.

TITLE I--AMENDMENTS TO THE SECURITIES ACT OF 1933

Sec. 101. AUTHORITY OF A COURT TO IMPOSE MONEY PENALTIES AND TO PROHIBIT PERSONS FROM SERVING AS OFFICERS AND DIRECTORS.

Section 20 of the Securities Act of 1933 (15 U.S.C. 77t) is amended by adding at the end thereof the following new subsections:

"(d) MONEY PENALTIES IN CIVIL ACTIONS.--

"(1) AUTHORITY OF COMMISSION.--Whenever it shall appear to the Commission that any person has violated any provision of this title, the rules or regulations thereunder, or a cease-and-desist order entered by the Commission pursuant to section 8A of this title, the Commission may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, upon a proper showing, a civil penalty to be paid by the person who committed such violation.

"(2) AMOUNT OF PENALTY.--The amount of the penalty shall be determined by the court in light of the facts and circumstances. For each violation, the amount of the penalty shall not exceed the greater of (1) $100,000 for an individual or $500,000 for any other person, or (2) the gross amount of pecuniary gain to such defendant as a result of the violation.

"(3) **PROCEDURES FOR COLLECTION.**--

"(A) **PAYMENT OF PENALTY TO TREASURY.**--A penalty imposed under this section shall be payable into the Treasury of the United States.

"(B) **COLLECTION OF PENALTIES.**--If a person upon whom such a penalty is imposed shall fail to pay such penalty within the time prescribed in the court's order, the Commission may refer the matter to the Attorney General who shall recover such penalty by action in the appropriate United States district court.

"(C) **REMEDY NOT EXCLUSIVE.**--The actions authorized by this subsection may be brought in addition to any other action that the Commission or the Attorney General is entitled to bring.

"(D) **JURISDICTION AND VENUE.**--For purposes of section 22 of this title, actions under this section shall be actions to enforce a liability or a duty created by this title.

"(4) SPECIAL PROVISIONS RELATING TO A VIOLATION OF A CEASE-AND-DESIST ORDER.--In an action to enforce a cease-and-desist order entered by the Commission pursuant to section 8A, each separate violation of such an order shall be a separate offense, except that in the case of a violation through a continuing failure to comply with such an order, each day of the failure to comply with the order shall be deemed a separate offense.

"(e) AUTHORITY OF A COURT TO PROHIBIT PERSONS FROM SERVING AS OFFICERS AND DIRECTORS.--In any proceeding under subsection (b), the court may prohibit, conditionally or unconditionally, and permanently or for such period of time as it shall determine, any person found to have violated section 17(a)(1) of this title from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l) or that is required to file reports pursuant to section 15(d) of such Act (15 U.S.C. 78o(d))."

Sec. 102. CEASE-AND-DESIST AUTHORITY.

The Securities Act of 1933 (15 U.S.C. 77 et seq.) is amended by adding at the end of section 8 the following new section 8A:

"**Sec. 8A. CEASE-AND-DESIST PROCEEDINGS.**--

"**(a) AUTHORITY OF THE COMMISSION.**--If the Commission finds, after notice and opportunity for hearing, that any person is violating, has violated, or is about to violate any provision of this title, or any rule or regulation thereunder, the Commission may publish its findings and enter an order requiring such person, and any other person who is, was, or would be a cause of the violation, due to an act or omission such other person knew or should have known would contribute to such violation, to cease and desist from committing or causing such violation and any future violation of the same provision, rule, or regulation. Such order may, in addition to requiring a person to cease and desist from committing or causing a violation, require such person to comply, or to take steps to effect compliance, with such provision, rule or regulation, upon such terms and conditions and within such time as the Commission may specify in such order. Any such order may, as the Commission deems appropriate, require future compliance or steps to effect future compliance, either permanently or for such period of time as the Commission may specify, with such provision, rule or regulation with respect to any security, any issuer, or any other person.

"(b) HEARING.--The notice instituting proceedings pursuant to subsection (a) shall fix a hearing date not earlier than thirty days nor later than sixty days after service of the notice unless an earlier or a later date is set by the Commission with the consent of any respondent so served.

"(c) TEMPORARY ORDER.--Whenever the Commission determines that the violation or threatened violation specified in the notice instituting proceedings pursuant to subsection (a), or the continuation thereof, is likely to result in dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest, including, but not limited to, losses to the Securities Investor Protection Corporation, prior to the completion of the proceedings, the Commission may enter a temporary order requiring the respondent to cease and desist from the violation or threatened violation and to take such action to prevent the violation or threatened violation and to prevent dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest as the Commission deems appropriate pending completion of such proceeding. Such order shall become effective upon service upon the respondent and, unless set aside, limited, or suspended by the Commission or a court of competent jurisdiction, shall remain effective and enforceable pending the completion of the proceedings.

"(d) JUDICIAL REVIEW OF TEMPORARY ORDER.--

"(1) PROCEDURE.--Within ten days after a respondent has been served with a temporary cease-and-desist order entered pursuant to subsection (c), the respondent may apply to the United States district court for the district in which the respondent resides or has his principal place of business, or for the District of Columbia, for an order setting aside, limiting, or suspending the effectiveness or enforcement of the order, and such court shall have sole jurisdiction to enter such an order.

"(2) NO AUTOMATIC STAY OF TEMPORARY ORDER.--The commencement of proceedings under this subsection shall not, unless specifically ordered by the court, operate as a stay of the Commission's order.

"(3) EXCLUSIVE REVIEW.--Section 9(a) of this title shall not apply to a temporary order entered pursuant to this section."

"(e) AUTHORITY TO ENTER AN ORDER REQUIRING AN ACCOUNTING AND DISGORGEMENT.--In any cease-and-desist proceeding under subsection (a), the Commission may enter an order requiring accounting and disgorgement, including reasonable interest. The

Commission is authorized to adopt rules, regulations and orders concerning payments to investors, rates of interest, periods of accrual, and such other matters as it deems appropriate to implement this subsection.

TITLE II--AMENDMENTS TO THE SECURITIES EXCHANGE ACT OF 1934

Sec. 201. ENFORCEMENT OF TITLE.

Section 21 of the Securities Exchange Act of 1934 (15 U.S.C. 78u(d)) is amended --

(1) by redesignating subsection (d) as paragraph (d)(1);

(2) by adding after paragraph (d)(1) the following new paragraphs:

"(2) AUTHORITY OF A COURT TO PROHIBIT PERSONS FROM SERVING AS OFFICERS AND DIRECTORS.--In any proceeding under Subsection (d)(1), the court may prohibit, conditionally or unconditionally, and permanently or for such period of time as it shall determine, any person found to have violated section 10(b) of this title or the rules or regulations thereunder from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 12 of this title or that is required to file reports pursuant to subsection (d) of section 15 of this title.

"(3) MONEY PENALTIES IN CIVIL ACTIONS.--

"(A) AUTHORITY OF COMMISSION.--Whenever it shall appear to the Commission that any person has violated any provision of this title, the rules or regulations thereunder, or a cease-and-desist order entered by the Commission pursuant to section 21C of this title, other than by committing a violation subject to a penalty pursuant to section 21A, the Commission may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, upon a proper showing, a civil penalty to be paid by the person who committed such violation.

"(B) AMOUNT OF PENALTY.--The amount of the penalty shall be determined by the court in light of the facts and circumstances. For each violation, the amount of the penalty shall not exceed the greater of (1) $100,000 for a natural person or $500,000 for any other person, or (2) the gross amount of pecuniary gain to such defendant as a result of the violation.

"(C) PROCEDURES FOR COLLECTION.--

"(i) PAYMENT OF PENALTY TO TREASURY.--A penalty imposed under this section shall be payable into the Treasury of the United States.

"(ii) COLLECTION OF PENALTIES.--If a person upon whom such a penalty is imposed shall fail to pay such penalty within the time prescribed in the court's order, the Commission may refer the matter to the Attorney General who shall recover such penalty by action in the appropriate United States district court.

"(iii) REMEDY NOT EXCLUSIVE.--The actions authorized by this paragraph may be brought in addition to any other action that the Commission or the Attorney General is entitled to bring.

"(iv) JURISDICTION AND VENUE.--For purposes of section 27 of this title, actions under this paragraph shall be actions to enforce a liability or a duty created by this title.

"(D) SPECIAL PROVISIONS RELATING TO A VIOLATION OF A CEASE-AND-DESIST ORDER.--

"(i) SEPARATE OFFENSES.--In an action to enforce a cease-and-desist order entered by the Commission pursuant to section 21C, each separate violation of such order shall be a separate offense, except that in the case of a violation through a continuing failure to comply with the order, each day of the failure to comply shall be deemed a separate offense.

"(ii) MINIMUM PENALTY FOR VIOLATIONS OF SECTION 16(a).--In an action to enforce a cease-and-desist order issued pursuant to section 21C against violations of the reporting requirements of section 16(a) of this title, the court shall impose a penalty of not less than $100 for each day of the failure to comply with the order."

Sec. 202. CIVIL REMEDIES IN ADMINISTRATIVE PROCEEDINGS

(a) The Securities Exchange Act of 1934 is amended by adding at the end of section 21A (15 U.S.C. 78u(A)) the following new section:

"Sec. 21B. CIVIL REMEDIES IN ADMINISTRATIVE PROCEEDINGS.--

"(a) COMMISSION AUTHORITY TO ASSESS MONEY PENALTIES.--In any proceeding instituted pursuant to sections 15(b)(4), 15(b)(6), 15B, 15C, or 17A of this title against any person, the Commission or the appropriate regulatory agency may impose a civil penalty if it finds, on the record after notice and opportunity for hearing, that such person--

"(1) has willfully violated any provision of the Securities Act of 1933 (15 U.S.C. 77a et seq.), the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 et seq.), or this title, or the rules or regulations thereunder, or the rules of the Municipal Securities Rulemaking Board;

"(2) has willfully aided, abetted, counseled, commanded, induced, or procured such a violation by any other person;

"(3) has willfully made or caused to be made in any application for registration or report required to be filed with the Commission or with any other appropriate regulatory agency under this title, or in any proceeding before the Commission with respect to registration, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which is required to be stated therein; or

"(4) has failed reasonably to supervise within the meaning of section 15(b)(4)(E) of this title, with a view to preventing violations of the provisions of such statutes, rules and regulations, another person who commits such a violation, if such other person is subject to his supervision;

and that such penalty is in the public interest.

"(b) **MAXIMUM AMOUNT OF PENALTY.**--The maximum amount of penalty for each such act or omission described in paragraph (1) shall be $100,000 for a natural person or $500,000 for any other person.

"(c) **DETERMINATION OF PUBLIC INTEREST.**--In considering under this section whether a penalty is in the public interest, the Commission or the appropriate regulatory agency may consider --

"(1) whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;

"(2) the harm to other persons resulting either directly or indirectly from such act or omission;

"(3) the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior;

"(4) whether such person previously has been found by the Commission, another appropriate regulatory agency or a self-regulatory organization to have violated the federal securities laws, state securities laws, or the rules of a self-regulatory organization, has been enjoined by a court of competent jurisdiction from violations of such laws or rules, or has been convicted by a court of competent jurisdiction of violations of such laws or of any felony or misdemeanor described in section 15(b)(4)(B) of this title;

"(5) the need to deter such person and other persons from committing such acts or omissions; and

"(6) such other matters as justice may require.

"(d) **EVIDENCE CONCERNING ABILITY TO PAY.**--In any proceeding in which the Commission or the appropriate regulatory agency may impose a penalty under this section, a respondent may present evidence of the respondent's ability to pay such penalty. The Commission or the appropriate regulatory agency may, in its discretion, consider such evidence in determining whether such penalty is in the public interest. Such evidence may relate to the extent of such person's ability to continue in business and the collectability of a penalty, taking into account any other claims of the United States or third parties upon such person's assets and the amount of such person's assets.

"(e) **AUTHORITY TO ENTER AN ORDER REQUIRING AN ACCOUNTING AND DISGORGEMENT.**--In any proceeding in which the Commission or the appropriate regulatory agency may impose a penalty under this section, the Commission or the appropriate regulatory agency may enter an order requiring accounting and a disgorgement, including reasonable interest. The Commission is authorized to adopt rules, regulations and orders concerning payments to investors, rates of interest, and such other matters as it deems appropriate to implement this subsection."

(b) Conforming Amendment.--The heading of section 21A of this title (15 U.S.C. 78u-1) is amended to read as follows:

"Sec. 21A. CIVIL PENALTIES FOR INSIDER TRADING"

Sec. 203. CEASE-AND-DESIST AUTHORITY

The Securities Exchange Act of 1934 is amended by adding after section 21B (15 U.S.C.78u-_) the following new section:

"SEC. 21C. CEASE-AND-DESIST PROCEEDINGS.--

"(a) AUTHORITY OF THE COMMISSION.--If the Commission finds, after notice and opportunity for hearing, that any person is violating, has violated, or is about to violate any provision of this title, or any rule or regulation thereunder, the Commission may publish its findings and enter an order requiring such person, and any other person who is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation, to cease and desist from committing or causing such violation and any future violation of the same provision, rule, or regulation. Such order may, in addition to requiring a person to cease and desist from committing or causing a violation, require such person to comply, or to take steps to effect compliance, with such provision, rule or regulation, upon such terms and within such time as the Commission may specify in such order. Any such order may, as the Commission deems appropriate, require future compliance or steps to effect future compliance, either permanently or for such period of time as the Commission may specify, with such provision, rule or regulation with respect to any security, any issuer, or any other person.

"(b) **HEARING.**--The notice instituting proceedings pursuant to subsection (a) shall fix a hearing date not earlier than thirty days nor later than sixty days after service of the notice unless an earlier or a later date is set by the Commission with the consent of any respondent so served.

"(c) **TEMPORARY ORDER.**--Whenever the Commission determines that the violation or threatened violation specified in the notice instituting proceedings pursuant to subsection (a), or the continuation thereof, is likely to result in dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest, including, but not limited to, losses to the Securities Investor Protection Corporation, prior to the completion of the proceedings, the Commission may enter a temporary order requiring the respondent to cease and desist from the violation or threatened violation and to take such action to prevent the violation or threatened violation and to prevent dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest as the Commission deems appropriate pending completion of such proceedings. Such order shall become effective upon service upon the respondent and, unless set aside, limited, or suspended by the Commission or a court of competent jurisdiction, shall remain effective and enforceable pending the completion of the proceedings.

"(d) JUDICIAL REVIEW OF TEMPORARY ORDER.--

"(1) PROCEDURE.--Within ten days after a respondent has been served with a temporary cease-and-desist order entered pursuant to subsection (c), the respondent may apply to the United States district court for the district in which the respondent resides or has his principal place of business, or for the District of Columbia, for an order setting aside, limiting, or suspending the effectiveness or enforcement of the order, and such court shall have sole jurisdiction to enter such an order.

"(2) NO AUTOMATIC STAY OF TEMPORARY ORDER.--The commencement of proceedings under this subsection shall not, unless specifically ordered by the court, operate as a stay of the Commission's order.

"(3) EXCLUSIVE REVIEW.--Section 25 of this title shall not apply to a temporary order entered pursuant to this section."

"(e) AUTHORITY TO ENTER AN ORDER REQUIRING AN ACCOUNTING AND DISGORGEMENT.--In any cease-and-desist proceeding under subsection (a), the Commission may enter an order requiring accounting and disgorgement, including reasonable interest. The Commission is authorized to adopt rules, regulations and orders concerning payments to investors, rates of interest, periods of accrual, and such other matters as it deems appropriate to implement this subsection.

Sec. 204. CONFORMING AMENDMENTS TO SECTION 15B.

Section 15B(c)(6)(A) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-4(c)(6)(A)) is amended --

(1) by replacing "and the nature" and inserting ", the nature";

(2) by striking "proposed action and" and inserting "proposed action, and whether the Commission is seeking a monetary penalty against such municipal securities dealer or such associated person pursuant to section 21B of this title; and".

TITLE III--AMENDMENTS TO THE INVESTMENT COMPANY ACT OF 1940

Sec. 301. CIVIL REMEDIES IN ADMINISTRATIVE PROCEEDINGS

Section 9 of the Investment Company Act of 1940 (15 U.S.C. 80a-9) is amended --

(1) by redesignating subsection (d) as subsection (g);

(2) by adding after subsection (c) the following new subsections:

"(d) MONEY PENALTIES IN ADMINISTRATIVE PROCEEDINGS.--

"(1) COMMISSION AUTHORITY.--In any proceeding instituted pursuant to subsection (b) against any person, the Commission may impose a civil penalty if it finds, on the record after notice and opportunity for hearing, that such person --

"(A) has willfully violated any provision of the Securities Act of 1933 (15 U.S.C. 77a et seq.), the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 et seq.), or this title, or the rules or regulations thereunder;

"(B) has willfully aided, abetted, counseled, commanded, induced, or procured such a violation by any other person; or

"(C) has willfully made or caused to be made in any registration statement, application, or report required to be filed with the Commission under this title, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such registration statement, application, or report any material fact which was required to be stated therein;

and that such penalty is in the public interest.

"(2) MAXIMUM AMOUNT OF PENALTY.--The maximum amount of the penalty for each such act or omission described in paragraph (1) shall be $100,000 for a natural person or $500,000 for any other person.

"(3) DETERMINATION OF PUBLIC INTEREST.--In considering under this section whether a penalty is in the public interest, the Commission may consider --

"(A) whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;

"(B) the harm to other persons resulting either directly or indirectly from such act or omission;

"(C) the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior;

"(D) whether such person previously has been found by the Commission, another appropriate regulatory agency or a self-regulatory organization to have violated the federal securities laws, state securities laws, or the rules of a self-regulatory organization, has been enjoined by a court of competent jurisdiction from violations of such laws or rules, or has been convicted by a court of competent jurisdiction of violations of such laws or of any felony or misdemeanor described in section 203(e)(2) of title II of this Act;

"(E) the need to deter such person and other persons from committing such acts or omissions; and

"(F) such other matters as justice may require.

"(4) EVIDENCE CONCERNING ABILITY TO PAY.--In any proceeding in which the Commission may assess a penalty under this section, a respondent may present evidence of the respondent's ability to pay such penalty. The Commission may, in its discretion, consider such evidence in determining whether such penalty is in the public interest. Such evidence may relate to the extent of such person's ability to continue in business, and the collectability of a penalty, taking into account any other claims of the United States or third parties upon such person's assets and the amount of such person's assets.

"(e) AUTHORITY TO ENTER AN ORDER REQUIRING AN ACCOUNTING AND DISGORGEMENT.--In any proceeding in which the Commission may impose a penalty under this section, the Commission may enter an order requiring accounting and a disgorgement, including reasonable interest. The Commission is authorized to adopt rules, regulations and orders concerning payments to investors, rates of interest, and such other matters as it deems appropriate to implement this subsection.

"(f) CEASE-AND-DESIST PROCEEDINGS.--

"(1) AUTHORITY OF THE COMMISSION.--If the Commission finds, after notice and opportunity for hearing, that any person is violating, has violated, or is about to violate any provision of this title, or any rule or regulation thereunder, the Commission may publish its findings and enter an order requiring such person, and any other person who is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation, to cease and desist from committing or causing such violation and any future violation of the same provision, rule, or regulation. Such order may, in addition to requiring a person to cease and desist from committing or causing a violation, require such person to comply, or to take steps to effect compliance, with such provision, rule or regulation, upon such terms and conditions and for such time as the Commission may specify in such order. Any such order may, as the Commission deems appropriate, require future compliance or steps to effect future compliance, either permanently or for such period of time as the Commission may specify, with such provision, rule or regulation with respect to any security, any issuer, or any other person.

"(2) HEARING.--The notice instituting proceedings pursuant to subsection (f)(1) shall fix a hearing date not earlier than thirty days nor later than sixty days after service of the notice unless an earlier or a later date is set by the Commission with the consent of any respondent so served.

"(3) TEMPORARY ORDER.--Whenever the Commission determines that the violation or threatened violation specified in the notice instituting proceedings pursuant to subsection (f)(1), or the continuation thereof, is likely to result in dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest, including, but not limited to, losses to the Securities Investor Protection Corporation, prior to the completion of the proceeding, the Commission may enter a temporary order requiring the respondent to cease and desist from the violation or threatened violation and to take such action to prevent the violation or threatened violation and to prevent dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest as the Commission deems appropriate pending completion of such proceedings. Notwithstanding section 40(a) of this title, such order shall become effective upon service upon the respondent and, unless set aside, limited, or suspended by the Commission or a court of competent jurisdiction, shall remain effective and enforceable pending the completion of the proceedings.

"(4) JUDICIAL REVIEW OF TEMPORARY ORDER.--

"(A) PROCEDURE.--Within ten days after a respondent has been served with a temporary cease-and-desist order entered pursuant to subsection (3), the respondent may apply to the United States district court for the district in which the respondent resides or has his principal place of business, or for the District of Columbia, for an order setting aside, limiting, or suspending the effectiveness or enforcement of the order, and such court shall have sole jurisdiction to enter such an order.

"(B) NO AUTOMATIC STAY OF TEMPORARY ORDER.--The commencement of proceedings under this subsection shall not, unless specifically ordered by the court, operate as a stay of the Commission's order.

"(C) EXCLUSIVE REVIEW.--Section 43 of this title shall not apply to a temporary order entered pursuant to this section."

"(5) AUTHORITY TO ENTER AN ORDER REQUIRING AN ACCOUNTING AND DISGORGEMENT.--In any cease-and-desist proceeding under subsection (f)(1), the Commission may enter an order requiring accounting and disgorgement, including reasonable interest. The Commission is authorized to adopt rules, regulations and orders concerning payments to investors, rates of interest, and periods of accrual, such other matters as it deems appropriate to implement this subsection."; and

(3) in redesignated subsection (g), by striking "subsections (a) through (c) of".

Sec. 302. MONEY PENALTIES IN CIVIL ACTIONS.

Section 42 of the Investment Company Act of 1940 (15 U.S.C. 80a-41) is amended by adding at the end thereof the following new subsection:

"(e) **MONEY PENALTIES IN CIVIL ACTIONS.**--

"(1) **AUTHORITY OF COMMISSION.**--Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder, or a cease-and-desist order entered pursuant to section 9(f) of this title, the Commission may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, upon a proper showing, a civil penalty to be paid by the person who committed such violation.

"(2) **AMOUNT OF PENALTY.**--The amount of the penalty shall be determined by the court in light of the facts and circumstances. For each violation, the amount of the penalty shall not exceed the greater of (1) $100,000 for a natural person or $500,000 for any other person, or (2) the gross amount of pecuniary gain to such defendant as a result of the violation.

"(3) **PROCEDURES FOR COLLECTION.**--

"(A) **PAYMENT OF PENALTY TO TREASURY.**--A penalty imposed under this section shall be payable into the Treasury of the United States.

"(B) **COLLECTION OF PENALTIES.**--If a person upon whom such a penalty is imposed shall fail to pay such penalty within the time prescribed in the court's order, the Commission may refer the matter to the Attorney General who shall recover such penalty by action in the appropriate United States district court.

"(C) **REMEDY NOT EXCLUSIVE.**--The actions authorized by this subsection may be brought in addition to any other action that the Commission or the Attorney General is entitled to bring.

"(D) **JURISDICTION AND VENUE.**--For purposes of section 44 of this title, actions under this paragraph shall be actions to enforce a liability or a duty created by this title."

"(4) **SPECIAL PROVISIONS RELATING TO A VIOLATION OF A CEASE-AND-DESIST ORDER.**--In an action to enforce a cease-and-desist order entered by the Commission pursuant to section 9(f), each separate violation of such order shall be a separate offense, except that in the case of a violation through a continuing failure to comply with such an order each day of the failure to comply shall be deemed a separate offense."

TITLE IV--AMENDMENTS TO THE INVESTMENT ADVISERS ACT OF 1940

Sec. 401. CIVIL REMEDIES IN ADMINISTRATIVE PROCEEDINGS.

Section 203 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3) is amended by adding at the end thereof the following new subsections:

"(i) MONEY PENALTIES IN ADMINISTRATIVE PROCEEDINGS.--

"(1) **AUTHORITY OF COMMISSION.**--In any proceeding instituted pursuant to subsection (e) or (f) against any person, the Commission may impose a civil penalty if it finds, upon the record after notice and opportunity for hearing, that such person

"(A) has willfully violated any provision of the Securities Act of 1933 (15 U.S.C. 77a et seq.), the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), or this title, or the rules or regulations thereunder;

"(B) has willfully aided, abetted, counseled, commanded, induced, or procured such a violation by any other person;

"(C) has willfully made or caused to be made in any application for registration or report required to be filed with the Commission under this title, or in any proceeding before the Commission with respect to registration, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such registration statement, application, or report any material fact which was required to be stated therein; or

"(D) has failed reasonably to supervise, within the meaning of section 203(e)(5) of this title, with a view to preventing violations of the provisions of this title and such rules and regulations, another person who commits such a violation, if such other person is subject to his supervision;

and that such penalty is in the public interest.

"(2) **MAXIMUM AMOUNT OF PENALTY.**--The maximum amount of the penalty for each act or omission described in paragraph (1) shall be $100,000 for a natural person or $500,000 for any other person.

"(3) **DETERMINATION OF PUBLIC INTEREST.**--In considering under this section whether a penalty is in the public interest, the Commission may consider --

"(A) whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;

"(B) the harm to other persons resulting either directly or indirectly from such act or omission;

"(C) the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior;

"(D) whether such person previously has been found by the Commission, another appropriate regulatory agency, or a self-regulatory organization to have violated the federal securities laws, state securities laws, or the rules of a self-regulatory organization, has been enjoined by a court of competent jurisdiction from violations of such laws or rules, or has been convicted by a court of competent jurisdiction of violations of such laws or of any felony or misdemeanor described in section 203(e)(2) of this title;

"(E) the need to deter such person and other persons from committing such acts or omissions; and

"(F) such other matters as justice may require.

"(4) EVIDENCE CONCERNING ABILITY TO PAY.--In any proceeding in which the Commission may impose a penalty under this section, a respondent may present evidence of the respondent's ability to pay such penalty. The Commission may, in its discretion, consider such evidence in determining whether such penalty is in the public interest. Such evidence may relate to the extent of such person's ability to continue in business and the collectability of a penalty, taking into account any other claims of the United States or third parties upon such person's assets and the amount of such person's assets.

"(j) AUTHORITY TO ENTER AN ORDER REQUIRING AN ACCOUNTING AND DISGORGEMENT.--In any proceeding in which the Commission may impose a penalty under this section, the Commission may enter an order requiring accounting and disgorgement, including reasonable interest. The Commission is authorized to adopt rules, regulations and orders concerning payments to investors, rates of interest, and such other matters as it deems appropriate to implement this subsection.

"(k) CEASE-AND-DESIST PROCEEDINGS.--

"(1) AUTHORITY OF THE COMMISSION.--If the Commission finds, after notice and opportunity for hearing, that any person is violating, has violated, or is about to violate any provision of this title, or any rule or regulation thereunder, the Commission may publish its findings and enter an order requiring such person, and any other person who is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation, to cease and desist from committing or causing such violation and any future violation of the same provision, rule, or regulation. Such order may, in addition to requiring a person to cease and desist from committing or causing a violation, require such person to comply, or to take steps to effect compliance, with such provision, rule or regulation, upon such terms and conditions and within such time as the Commission may specify in such order. Any such order may, as the Commission deems appropriate, require future compliance or steps to effect future compliance, either permanently or for such period of time as the Commission may specify, with such provision, rule or regulation with respect to any security, any issuer, or any other person.

"(2) **HEARING.**--The notice instituting proceedings pursuant to subsection (k)(1) shall fix a hearing date not earlier than thirty days nor later than sixty days after service of the notice unless an earlier or a later date is set by the Commission with the consent of any respondent so served.

"(3) **TEMPORARY ORDER.**--Whenever the Commission determines that the violation or threatened violation specified in the notice instituting proceedings pursuant to subsection (k)(1), or the continuation thereof, is likely to result in dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest, including, but not limited to, losses to the Securities Investor Protection Corporation, prior to the completion of the proceedings, the Commission may enter a temporary order requiring the respondent to cease and desist from the violation or threatened violation and to take such action to prevent the violation or threatened violation and to prevent dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest as the Commission deems appropriate pending completion of such proceedings. Notwithstanding section 211(c) of this title, such order shall become effective upon service upon the respondent and, unless set aside, limited, or suspended by the Commission or a court of competent jurisdiction, shall remain effective and enforceable pending the completion of the proceedings.

"(4) **JUDICIAL REVIEW OF TEMPORARY ORDER.**--

"(A) **PROCEDURE.**--Within ten days after a respondent has been served with a temporary cease-and-desist order entered pursuant to subsection (3), the respondent may apply to the United States district court for the district in which the respondent resides or has his principal place of business, or for the District of Columbia, for an order setting aside, limiting, or suspending the effectiveness or enforcement of the order, and such court shall have sole jurisdiction to enter such an order.

"(B) **NO AUTOMATIC STAY OF TEMPORARY ORDER.**--The commencement of proceedings under this subsection shall not, unless specifically ordered by the court, operate as a stay of the Commission's order.

"(C) **EXCLUSIVE REVIEW.**--Section 213 of this title shall not apply to a temporary order entered pursuant to this section."

"(5) **AUTHORITY TO ENTER AN ORDER REQUIRING AN ACCOUNTING AND DISGORGEMENT.**--In any cease-and-desist proceeding under subsection (k)(1), the Commission may enter an order requiring accounting and disgorgement, including reasonable interest. The Commission is authorized to adopt rules, regulations and orders concerning payments to investors, rates of interest, periods of accrual, and such other matters as it deems appropriate to implement this subsection.

Sec. 402. MONEY PENALTIES IN CIVIL ACTIONS.

Section 209 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-9) is amended by adding at the end thereof the following new subsection:

"(e) **MONEY PENALTIES IN CIVIL ACTIONS.**--

"(1) **AUTHORITY OF COMMISSION.**--Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder, or a cease-and-desist order entered by the Commission pursuant to section 203(k) of this title, the Commission may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, upon a proper showing, a civil penalty to be paid by the person who committed such violation.

"(2) **AMOUNT OF PENALTY.**--The amount of the penalty shall be determined by the court in light of the facts and circumstances. For each violation, the amount of the penalty shall not exceed the greater of (1) $100,000 for a natural person or $500,000 for any other person, or (2) the gross amount of pecuniary gain to such defendant as a result of the violation.

"(3) **PROCEDURES FOR COLLECTION.**--

"(A) **PAYMENT OF PENALTY TO TREASURY.**--A penalty imposed under this section shall be payable into the Treasury of the United States.

"(B) COLLECTION OF PENALTIES.--If a person upon whom such a penalty is imposed shall fail to pay such penalty within the time prescribed in the court's order, the Commission may refer the matter to the Attorney General who shall recover such penalty by action in the appropriate United States district court.

"(C) REMEDY NOT EXCLUSIVE.--The actions authorized by this subsection may be brought in addition to any other action that the Commission or the Attorney General is entitled to bring.

"(D) JURISDICTION AND VENUE.--For purposes of section 214 of this title, actions under this paragraph shall be actions to enforce a liability or a duty created by this title."

"(4) SPECIAL PROVISIONS RELATING TO A VIOLATION OF A CEASE-AND-DESIST ORDER.--In an action to enforce a cease-and-desist order entered by the Commission pursuant to section 203(k), each separate violation of such order shall be a separate offense, except that in the case of a violation through a continuing failure to comply with the order, each day of the failure to comply shall be deemed a separate offense."

SEC. 403. CONFORMING AMENDMENT TO SECTION 214.

Section 214 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-14) is amended by inserting --

(a) after "all suits in equity", the following: "and actions at law brought to enforce any liability or duty created by, or"; and

(b) after "Any suit or action", the following: "to enforce any liability or duty created by, or".

TITLE V--AMENDMENTS TO THE CRIMINAL CODE

SEC. 501. GRAND JURY SECRECY.

(a) Chapter 215 of title 18, United States Code, is amended by adding after section 3322 the following new section:

"Sec. 3323. Disclosure of certain matters occurring before grand jury for use in enforcing securities laws--

"(a)(1) Upon motion of an attorney for the government, a court may direct disclosure of matters occurring before a grand jury during an investigation of conduct that may constitute a violation of any provision of the securities laws, as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78(c)(a)(47), to identified personnel of the Securities and Exchange Commission for use in relation to any matter within the jurisdiction of the Securities and Exchange Commission.

"(2) A court may issue an order under paragraph (1) upon a finding of a substantial need.

"(b) A person to whom a matter has been disclosed under this section shall not use such matter other than for the purpose for which such disclosure was authorized.

"(c) As used in this section, the terms 'attorney for the government' and 'grand jury information' have the meanings given to those terms in section 3322 of this title.".

(b) **CLERICAL AMENDMENT.**--The table of sections at the beginning of chapter 215 of title 18, United States Code, is amended by adding after the item relating to section 3322 the following:

"Sec. 3323. Disclosure of certain matters occurring before grand jury for use in enforcing securities laws.".

THE SECURITIES LAW ENFORCEMENT REMEDIES ACT OF 1989

THURSDAY, FEBRUARY 8, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, DC.

The subcommittee met at 9:35 a.m., in room SD–538, Dirksen Senate Office Building, Senator Richard H. Bryan presiding.

Present: Senators Bryan, Riegle, Sasser, Shelby, Wirth, Heinz, Pressler, D'Amato, and Graham.

OPENING STATEMENT OF SENATOR BRYAN

Senator BRYAN. Let me preface my remarks by indicating that the chairman of our subcommittee has a very difficult time conflict this morning. I know that he has a statement that he wants incorporated and made a part of this record. And it will be incorporated and made a part of the record and, hopefully, he might be able to stop by here.

But, I would like to publicly acknowledge his leadership on this issue and the very strong support that we've had from the ranking member of the subcommittee, who joins us this morning, Senator Heinz.

Last year, I held a similar hearing to the one that's being held today in my own State of Nevada and was provided testimony about the prevalence of the sale of penny stocks and the fraud that accompanies the sale of a good many of them.

Time and time again, when I listen to businessmen out in our State talk about their concerns, one issue always comes up and that's the cost of capital. We hear of the virtues of investment, the long-term horizons and, rightly so. But, frequently, we are defeated before we get out of the starting blocks by capital costs which are higher than any of our major foreign competitors.

The whole issue of capital formation is affected and touched upon by today's topic. If small investors continue to get ripped off to the tune of an estimated $2 billion annually, if small investors continue to perceive the stock markets as manipulated by insider trading, then what hope do we really have of convincing small individuals to invest in America's future?

It's no wonder that our savings rate is the lowest of any of our industrial competitors and about one-fifth of the rate of savings in Japan.

Let me also applaud at this time the Securities and Exchange Commission's new chairman, Richard Breeden, for focusing its attention on the rising problem of the small investor fraud. Commission's efforts to combat a few highly visible insider trading cases has sent shock waves throughout Wall Street. With this underway, I believe it is high time now to focus on the vast majority of Americans who would qualify as small investors.

The Commission's "cold calling" rule is an important first step toward combating penny stock fraud. Passage of S. 647, the "Securities Law Enforcement Remedies Act," would also be very beneficial.

I would also like to compliment the North American Securities Administrators Association for their excellent work in this area. In my own State of Nevada, the Secretary of State's office has nearly doubled the number of enforcement actions against penny stock firms.

NASAA's penny stock report issued last fall is the most comprehensive analysis of the problem to date and provides a number of worthwhile recommendations for action.

Following up on that report, I have filed legislation, S. 2058, the Small Investor Protection Act. This bill bans blank check blind pool offerings which, by their very nature, has made them a leading vehicle for fraud and abuse in the penny stock market.

The bill also requires more enhanced and meaningful disclosure. And most importantly, the bill gives the Commission the ability to go after the source of this fraud and close down firms before they can abscond with their ill-gotten gains.

I am anxious to hear—and I know both Senator Heinz today and others who will be reviewing the record of this testimony—to hear the testimony of our witnesses.

We welcome their comments on the problem as well as solutions put forth by NASAA and other interested parties.

I notice that the chairman of the full committee, Senator Riegle, is here. If the chairman has no objection, I know Senator Heinz has a time constraint and I would like to yield to Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Thank you.

Before I yield to the witnesses, I would like to welcome Senator Bryan to the Securities Subcommittee. He is new to this subcommittee and he is chairing it. And I hope he is going to share with me the secret on how he managed to wrest the chairmanship of the committee away from Senator Dodd, for a very selfish reason:

I could put that to use at the conclusion of today's hearing.

As I say, I do want to welcome the witnesses. We hope that you will be extremely helpful in assisting the subcommittee in its examination of penny stock fraud and other crimes that prey on this Nation's small investors.

Penny stock investments may sound like pocket change but, in reality, penny stock car artists have managed to nickel and dime more than $2 billion a year from unsuspecting small investors.

Many of us have heard of pinching pennies, but these crooks can squeeze the life out of innocent investors by pitching penny stocks.

Fraudulent penny stock brokers don't work on Wall Street. They deal from a side street. They don't operate through trading rooms, they work out of boiler rooms.

Their funds don't come from commercial banks, they get their money by using telephone banks.

Yet, these swindlers control a multibillion dollar penny stock market which crashes every day on small investors around the country. Small investors are not the only victims of penny stock fraud. Many legitimate small and medium-sized companies rely on this market as an essential source of capital for growth and development.

Penny stock frauds drain the flow of capital to this market, which is the life blood of many legitimate and important American companies, even if they may be small.

The primary purpose of course of our Securities laws is to protect investors and ensure the integrity of our markets. These laws must be strong enough to put in jail those who seek to make a buck out of penny stock fraud.

We believe we have to pull the plug on their telephone banks and take the steam out of their boiler rooms.

Mr. Chairman, penny stock fraud is a crime. For that reason, we needed to enlist the aid of the Attorney General of the United States in our effort to combat this criminal activity.

Today, I've sent a letter to the Justice Department, to the attorney general, asking for a report on their efforts, to prosecute penny stock fraud, their assessment of the scope of this problem and the adequacy of their resources to deal with it.

Criminal prosecution of penny stock fraud is one approach to this problem that makes a lot of sense. That's with a "C".

Mr. Chairman, I thank you. I want to apologize both to you and Chairman Riegle and the witnesses. I have to go to a meeting on acid rain at 10 o'clock. I've got a Finance Committee hearing at 10 o'clock.

And I need to introduce the Presidents and Senator . . . his appointee, to the U.S. Civil Rights Commission, Mr. Russell Reddenbaugh, from my home State of Pennsylvania, at 10 o'clock. So, I'll be back shortly after 10 o'clock. [Laughter.]

Senator BRYAN. Thank you very much, Senator Heinz, for your comments. When you juggle all those activities and get back, let us know how you are able to do that. It's a remarkable schedule but it's a good indication of your interest and commitment.

Senator HEINZ. Mr. Chairman, in for a penny, in for a pound. [Laughter.]

Senator BRYAN. Indicating the kind of support and direction and leadership that's been provided not only to the subcommittee and its chairman is the attendance this morning of the chairman of the full committee.

I would like to yield now to Senator Riegle for any comments he would like to make.

OPENING STATEMENT OF CHAIRMAN RIEGLE

Senator RIEGLE. Thank you very much, Senator Bryan.

First, I want to commend the subcommittee, and particularly Senator Dodd and Senator Heinz, for pressing ahead with S. 647, the Securities Law Enforcement Remedies Act.

This is the second hearing now that will have been had since the Congress reconvened. I think this shows good movement and I want the subcommittee to know that there is full support at the full committee level to move ahead and mark up this legislation and get it enacted.

We do need the help of the SEC and the administration as we move along to expedite this process.

I want to say to you, Senator Bryan, how much I appreciate your leadership on the penny stock issue and the problem of fraud that has hit many people in the country. I think it's very important that we learn more as to how this has taken place and have a full record available to us, so that we can devise the appropriate legislative response.

I would just say that, in addition to considering penny stock fraud, the subcommittee will consider the impact of S. 647 on small investors generally because, obviously, we want small investors in the market. We want them to feel that the market is fairly operated with their interests in mind. And should we lose the small investor from the market—and there's been I think a number of events that have caused them to move away from participation—I think that's a serious long-term loss to the country.

So we need a more stabilizing force in the securities markets. And, obviously, cracking down on obviously fraudulent practices is one such step.

So I'm very interested in hearing from this group of witnesses that we have today. And, again, I want to commend you for taking the lead and I promise you my full support.

Senator BRYAN. Thank you very much, Mr. Riegle.

We are also joined by another one of the very active members of the subcommittee, Senator D'Amato.

I yield now to you for any statement you would like to make, Senator.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Thank you, Mr. Chairman.

At the outset, let me compliment you, Senator Bryan, for your interest and your work in this most important area of protecting the small investor. I want to commend you for your continued effort in this area. It's difficult and it's often kind of frustrating.

For years, Congress has heard tales of the most heinous types of predatory, fraudulent sales of penny stocks. I have to say that, if you look at the statistics, one would have to be alarmed at the growth of these practices.

Our able committee staff has informed me that the penny stocks, once looked upon as maybe a regional phenomenon, have grown to some 325 firms in 26 States.

Now, were this a wholly legitimate business, this would be good news. But, the fact that 34 percent of all complaints received by the SEC, are against 34 percent of all complaints that the SEC receives are against penny stock dealers makes it clear to me that this is not the case.

I am sure the estimate—and I'm saying it's an estimate—70 percent of those who invest in penny stocks lose their entire investment.

Mr. Chairman, we all know that our free enterprise system is designed to reward risk-taking and we must, therefore, encourage sophisticated, informed investors to take whatever risks they're comfortable with. Of course, the targets of these hit and run boiler room operators are not the types of people who should be making risky investments.

They're working people, elderly people, who invest their life savings. The fact, Mr. Chairman, is that I wholeheartedly concur with today's witness, Debra Thomason, when she says:

"Our hope is that laws can be made to put penny stock con men out of business."

I would add: For good.

So, indeed, I am tremendously supportive of these hearings. I want to commend Senator Dodd and Senator Heinz also for their legislative efforts in regard to penny stocks and the SEC.

I think their vigorous review of what is taking place, and encouragement of legislation to deal with some of the shortcomings, is certainly necessary.

Senator **Bryan**. Thank you very much, Senator D'Amato.

Without objection, we will incorporate and make a part of the record Senator Dodd's testimony in the event he is unable to join us this morning.

I also have statements from Senators Sasser, Sanford, Shelby, and Graham.

OPENING STATEMENT OF SENATOR DODD

Senator **Dodd**. Let me welcome everyone to our second hearing on S. 647, the Securities Enforcement Remedies Act of 1990, which Senator Heinz and I introduced last year at the request of the SEC. Today's hearing will focus on how that legislation will address some very serious enforcement problems affecting small investors. We also will consider S. 2057, the Small Investor Protection Act, which Senator Bryan introduced last week.

I want to begin by commending my colleague, Senator Bryan, for all of the work he has done in raising the issues that are the subject of today's hearing.

Soon after he came to the Senate, he talked with me about the problem of penny stock fraud, and he argued very forcefully that the SEC's existing enforcement tools were not adequate to address widespread abuse in that market. He was extremely persistent. He held a hearing on the issues in his own State of Nevada. And he was such a good advocate for the small investor, it was my view that he ought to chair a hearing of the subcommittee here in Washington.

I want to say to my colleague—I had every intention of staying here and enjoying the hearing while you served in the chair. But as you know, I have to leave shortly this morning to go to Nicaragua as part of the observer group for those elections. I know I will leave the hearing in very capable hands.

Let me also say that I am delighted to see my full committee chairman here today. Chairman Riegle, you have, I believe, come to every legislative hearing held by the Securities Subcommittee this year. Your support has been absolutely critical to our success in passing the securities legislation in the Senate last year and in moving the market reform bill through the committee last November. And I am very confident that your support for the enforcement legislation we will consider today will enable us to act on that measure this spring. We made a great deal of progress last week; I know Senator Bryan will advance the cause this morning, and I intend to make every effort to get the bill ready for full committee action within the next few months.

S. 647, the Securities Enforcement Remedies Act, is critical legislation for the small investor. By giving the SEC authority to ask a court for civil fines and the disgorgement of illicit gains, we're going to "up the ante" for those crooks and thieves who have been preying upon innocent investors in the penny stock market. By giving courts the power to bar those who have committed fraud from serving as officers and directors of public companies, the bill will keep those with a track record of fraud from continuing to rip off investors. And it's high time we do that.

The small investor is losing ground in our market. We've talked about this many times before.

On one front, he sees the market whipsawed by large institutions, using trade strategies in futures and stocks that have the effect, if not the intent, of creating dramatic price movements in the space of minutes. We hope to address at least some aspects of that problem with the Market Reform Act, and we still have a great deal of work to do in that area.

On the other front, the small investor is bombarded with "cold calls" by petty crooks, who call from "boiler rooms," pushing "blank check blind pools" and other worthless securities. Once an investor buys a stock, he finds there is no one to sell it to, after the insiders and promoters have bailed out.

I believe S. 647 will add tremendous new firepower to the SEC's enforcement arsenal for the benefit of small investors. And, I think we must ask the witnesses here today whether it goes far enough.

Even the SEC would agree that, when you're dealing with penny stock fraud, simply adding new enforcement penalties may not be enough. That certainly is the rationale behind the "cold call" rule. Senator Bryan would urge that we go even further, and place an outright ban on "blank check blind pools." I believe it might be appropriate—and I'll leave it to Senator Bryan's discretion—to ask the SEC whether any investor ever made money on a blank check blind pool? I suspect that for every one you find who made money, there will be hundreds who lost their entire investment.

Let me close by saying, the small investor built the great industrial base of this country. From the steel companies to the IBM's, AT&T's, General Motors, and countless other companies, large and small, our national economy was built on the confidence of small investors to risk their capital in our markets. I don't think we can say at this point, "Thank you, small investor, but we don't need you anymore.* * * After all, we've now got the General Motors and AT&T pension funds to carry us through."

We still need that small investor. He is a vital part of the liquidity and stability of our broader markets. And he is absolutely essential in providing the funds for the thousands of legitimate, small, start-up companies that create jobs for millions of Americans. The SEC, the States, and the NASD have done a tremendous job in attacking fraud in the penny stock market—but there's a great deal more to be done. I certainly pledge my support in that effort.

Let me commend you again, Senator Bryan, and also thank the witnesses for coming today.

OPENING STATEMENT OF SENATOR SASSER

Senator **Sasser**. Mr. Chairman, we are going to hear testimony today about a problem that is plaguing our securities markets. The advent of "penny stock" firms that prey on small investors is truly disturbing. Hundreds of individuals have lost their hard-earned savings to ruthless brokers and owners who make unconscionable profits. This penny stock scandal could damage the integrity of the entire securities market. Senator Dodd's bill contains many effective tools to fight penny stock fraud. I commend him for calling this timely hearing.

The small investor is a vanishing breed. Between the 1987 market crash, program trading, market abuses and the penny stock blight, individual investors are bypassing the stock market for other investments. This troubles me because I believe the small individual investor with his or her traditional long-term focus is the backbone of our capital markets. With the market shifting to an increasingly long focus, the participation of the individual is more critical than ever.

Moreover, the SEC seems to have been focusing on market manipulation in large trades and megadeals. Yet penny stock scandals reveal manipulation of a more onerous nature. Frequently, stocks are sold in companies that do not even exist. And they are sold to people with limited funds and little investment experience. Due to the lack of information available on the smaller penny stock companies, investors are often unaware of the risks involved in the stocks they are pressured to buy. Moreover, some individuals have encountered brokers who refuse to sell a client's stock once it shows a profit. All of these factors point to a regulatory system which has not yet taken enough measures to protect the interests of the individual investor.

We don't want to create so many requirements that legitimate small companies are shut out of the capital market. Yet, in addressing this question, we must create checks to ensure that businesses issuing publicly traded equities are legitimate.

The powers granted the SEC by Senator Dodd's bill will go far in enabling this agency to address the penny stock problem. This bill will allow the SEC to levy fines on violators, hitting them where it hurts most—by taking away their profits. The securities bill will also keep individuals who have been convicted of securities violations from serving in corporate management. I commend the SEC for the steps they have taken thus far to stop the penny stock problem through investor education. I look forward to the insightful testimony of our witnesses here today and their suggestions on how to address the penny stock problem and make the market an attractive investment opportunity for small investors once again.

OPENING STATEMENT OF SENATOR SANFORD

Senator **Sanford**. Thank you, Mr. Chairman, and I would like to thank our panel of witnesses for their excellent testimony. This morning's hearing focuses on a very serious problem in our capital markets.

I know we all cringed last year upon seeing the cover of Business Week with its lead story on fraud and scandal in the penny stock market. My concerns were only enhanced by the recent study by State regulators, who estimate that more than $2 billion is lost each year to fraud and abuse in the penny stock market.

At a time when we are very concerned about the small investor and the events and market developments that have caused the small investor to stay away from the markets, it is clear that taking strong steps to reduce the fraud and abuse in the penny stock would help restore some confidence in our market.

More than $2 billion of losses in fraud is simply unacceptable. We need to give the SEC and the State regulators the tools they need to curb this fraud. I applaud your efforts, Mr. Chairman, to combat this problem and I look forward to working with you, the SEC, and with the members of our panel to seek the best method to put an end to this swindling of innocent investors.

Thank you.

OPENING STATEMENT OF SENATOR SHELBY

Senator **Shelby**. Mr. Chairman, I am glad that you have called this hearing and I appreciate your efforts in finding a solution to the problem of penny stock fraud.

The rapid increase in the incidence and magnitude of complaints of penny stock fraud over the past decade is alarming and should be dealt with severely for two reasons. First, penny stock fraud is theft. Unjustified claims are made by coercive salesmen to entice investors to part with their hard earned money. Over the past decade, highly publicized stories of immense fortunes to be made in the market have encouraged unsophisticated investors to risk sometimes their life savings on speculative investments. Boiler room salesmen know this and prey on the unsuspecting.

Second, while it is necessary to provide further protection for investors, I consider the legitimate small businesses, seeking to attract capital, as even greater victims of penny stock fraud. Investors have the option of hanging up on boiler room salesmen, while legitimate businesses must compete for funds in the marketplace with these fraudulent firms, inevitably finding themselves suspect by association.

I commend the use of criminal penalties against these con artists. As we learned with the S&L crisis, there are insufficient deterrents to white collar crime; the threat of jail and the specter of being a true "criminal" seems an unlikely consequence. It is time to change that. I support criminal enforcement actions as well as stiff civil penalties.

I commend the SEC's efforts thus far and I look forward to the testimony of today's witnesses.

Thank you, Mr. Chairman.

OPENING STATEMENT OF SENATOR GRAHAM

Senator GRAHAM. Senator Bryan, I congratulate you for scheduling today's hearing on the problems with penny stocks. Penny stock fraud is a growing problem in Florida. Mr. Don Saxon, the director of the Securities Division of the Florida Office of the Comptroller, leads the fight on this issue and I welcome Don to the subcommittee. He is appearing with Susan Bryant.

For the record Mr. Chairman, I would like to provide copies of several public service newspaper columns provided by the Florida Comptroller's Office alerting Floridians to the potential abuses which may occur when they invest in penny stocks.

Senator BRYAN. We are joined this morning by a very distinguished panel, Mr. Richard Ketchum, Director of the Division of Market Regulation of the Securities and Exchange Commission; Mr. Joseph Goldstein, who is the Associate Director of the Division of Enforcement at the Securities and Exchange Commission and the Director of the Penny Stock Task Force; Susan Bryant, president of the North American Securities Administrators Association; and Mr. Frank J. Wilson, general counsel and executive vice president for law and regulatory policy of the National Association of Securities Dealers.

Mr. Ketchum and Mr. Goldstein, you submitted your testimony jointly to the committee. That entire testimony will be made a part of the record. We would like to ask you to begin, if you will, and try to observe, if you can, and keep it within a 5- or 10-minute timeframe so that the panel has an opportunity to ask each member of this panel a number of questions, which I'm sure they do.

STATEMENTS OF RICHARD KETCHUM, DIRECTOR, DIVISION OF MARKET REGULATION, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, DC, AND JOSEPH I. GOLDSTEIN, ASSOCIATE DIRECTOR, DIVISION OF ENFORCEMENT, SECURITIES AND EXCHANGE COMMISSION AND DIRECTOR, PENNY STOCK TASK FORCE, WASHINGTON, DC

Mr. GOLDSTEIN. Chairman Bryan, members of the subcommittee, I appreciate this opportunity to present testimony on behalf of the Commission regarding one of the most serious issues facing small investors, penny stock fraud.

The Commission has taken a number of steps in the enforcement area to increase the protections available to small investors. In addition to the regulatory measures, which will be described by Mr. Ketchum, losses to individual investors who are caught in fraudulent schemes in this market amount to far more than pennies.

When penny stock schemes collapse, innocent public investors are left holding worthless stock for which they paid their hard-earned savings, retirement nest eggs, college tuitions and downpayments for homes.

The victims also include small businesses, who cannot raise capital because investors are wary of investing in a harsh market. The profits to broker dealers and their sales persons can be enormous. For example, the U.S. attorney for the District of New Jersey reports that F.D. Roberts, a now defunct penny stock broker, which was the subject of criminal as well as SEC and State of New Jersey enforcement actions, realized gross trading profits of at least $67 million over a 3-year period.

Top stock brokers at some penny stock brokers earn $20,000 or $30,000 or more per month. Penny stocks are sold primarily over the telephone. Many brokers are trained in psychological sales techniques and use deceptive sales practices with emphasis on high-pressure methods to overcome objections that prospective buyers might have about purchasing penny stocks.

The brokers usually use sales scripts, which may contain numerous false statements about the company and its prospects. Once a broker has been "trained," and I put that in quotes, he or she then cold-calls sometimes hundreds of persons daily from telephone directories, college alumni lists and even client lists stolen from other brokerage firms.

Many of the individuals called by the brokers have little or no investment experience and limited financial resources.

Typically, these brokers do not make determinations that the securities they recommend are suitable investments for their customers' financial situation, investment objectives or investment experience.

Their mandate is to sell to any customer who can pay for the stock. For example, in one Commission action, a defrauded customer was a retired construction worker who lived in subsidized housing, and his primary source of income was his social security checks.

In response to these abuses, the Commission established the Penny Stock Task Force in October 1988. The task force identified four goals for the Commission in its efforts to combat penny stock fraud, stepped up enforcement activities, including criminal referrals when appropriate; increased coordination and information-sharing with other Federal, State and local regulators and prosecutors; targeted regulatory solutions and investor education.

The Commission has made significant progress in each of these areas. During the past fiscal year, the Commission has brought 68 enforcement actions involving penny stock fraud. Too often, the Commission's experience is, however, that the people responsible for organizing, financing and executing penny stock manipulation are not deterred by the civil remedies that are currently available to the Commission.

These civil remedies are viewed as part of the cost of doing business. Therefore, to deter penny stock fraud more effectively, the Commission has actively sought and been successful in eliciting the help of criminal prosecutors.

For example, the SEC has worked with the U.S. Attorney's Office and the FBI in Salt Lake City in an undercover operation that led to 10 indictments.

Similarly, the SEC worked with the U.S. Attorney's Office in New Jersey in bringing RICO indictments against three defendants in an elaborate penny stock scheme that cost investors more than $10 million.

These are only two examples of many cases in which the SEC has worked with criminal law enforcement authorities. We believe that Federal and State law enforcement authorities and self-regulators must work together to solve the problem of penny stock fraud.

The task force has helped forge a stronger network of communication and cooperation among regulators and prosecutors.

In the area of regulatory initiatives, the task force is reviewing the Commission's regulatory structure for the purpose of proposing regulations to prevent penny stock fraud.

A broad range of ideas have been discussed by the task force as well as with representatives from various State and Federal agencies. As a result of these discussions, the Commission adopted the Cold Calling Rule, rule 15c(2-6), which went into effect in January.

Mr. Ketchum will describe the rule and how it will work to protect investors from high-pressure, unsolicited sales tactics used in penny stock manipulations.

Enforcement and regulatory initiatives will help protect investors. The most effective force against penny stock fraud, however, is educated investors. Therefore, the Commission has focused on increased investor awareness on how to recognize and avoid penny stock schemes.

The task force has written and distributed three investor bulletins on penny stock frauds to more than 2 million investors. They have been distributed by banks and public utilities and others.

In the area of legislation, Congress has before it two proposals for legislative changes that would strengthen the Commission's enforcement program generally and would greatly aid in the protection of small investors.

The Senate bills were jointly introduced by Chairman Dodd of this subcommittee and Senator Heinz.

The Securities Law Enforcement Remedies Act would authorize the imposition of money penalties in civil and administrative proceedings, provide for the barring of corporate officers and directors who engage in fraudulent activities, add cease and desist authority to the Commission's arsenal of weapons against Securities law violators, and allow the Commission to have greater access to grand jury information.

The International Securities Enforcement Cooperation Act would further international enforcement cooperation, which is essential in prosecuting penny stock manipulators who operate across national borders. Investors from countries, including Great Britain, France, the Netherlands, Germany and Switzerland, Canada, and the United States have been victims of the same penny stock rings.

In addition to the two bills I just described, Chairman Bryan introduced last week S. 2057, the Small Investor Protection Act of 1990. We look forward to working with Chairman Bryan and the staff on the bill.

It is important to note that the picture is not completely bleak. Progress is being made against penny stock manipulators. The number of penny stock firms is declining. It also appears that the penny stock sales force is declining, as is the penny stock brokers' compensation in sales.

At the same time, the number of enforcement actions and criminal and civil referrals have gone up. Moreover, the cold calling rule should have a significant impact on manipulative activities.

In conclusion, penny stock fraud continues to be a significant danger to small investors. Much remains to be done from an enforcement, regulatory and legislative standpoint to eradicate this fraud. The Commission is committed to combating this danger and to devoting substantial resources to the protection of the public.

I will be pleased to respond to any questions.

Senator **Bryan**. Let me yield to Senator Shelby, who is a member of this subcommittee.

Senator **Shelby**. Mr. Chairman, I have an opening statement I would like to have included in the record.

Other than that, I want to commend you, Senator Dodd and Senator Riegle for putting this hearing together. I know it's widespread and we really haven't—I believe the enforcement people either don't have the money and the people or something, because it just gets deeper, as has been pointed out. And I think it needs to be eradicated.

Thank you, Mr. Chairman.

Senator **Bryan**. Thank you very much, Senator Shelby. Your statement will be made a part of the record.

We are joined by Mr. Ketchum. Let me just repeat we have had a chance to read your testimony. So, to the extent that you can highlight and we can provide an opportunity for the members of the committee to ask you some questions.

Mr. **Ketchum**. Thank you, Mr. Chairman. I appreciate the opportunity to appear before the subcommittee this morning to discuss these important issues affecting the confidence of small investors in the U.S. securities market.

As Director of the Commission's Division of Market Regulation, I have responsibility for developing regulatory programs affecting broker/dealers and the Broker/Dealer Examination Program.

I'd like to briefly discuss the manner in which those programs address penny stock fraud.

The Broker/Dealer Examination Program has been especially aggressive in seeking out penny stock fraud; 197 examinations of penny stock broker/dealers have been completed by the Commission staff in the past 19 months. These examinations uncovered serious violations that called for enforcement action.

Violations uncovered involved excessive markups, market manipulation, high-pressure boiler room sales practice abuses and misrepresentation concerning the business activity and financial condition of corporate issuers.

Forty-seven percent of these examinations were referred to the Commission's Division of Enforcement. And an additional 10 percent have been referred to the NASD for enforcement consideration.

The Commission has also targeted regulatory action to combat penny stock fraud. The Commission adopted, as you know, a new rule, rule 15c2–6 in August 1989 in order to impose an objective and readily reviewable requirement governing the process by which new customers are induced to purchase penny stocks.

The new rule, which became effective on January 1, 1990, should prove to be an effective deterrent to sales practice abuses involving penny stocks as well as a useful new enforcement tool against broker/dealers who engage in such conduct.

Penny stocks often are peddled through high-pressure cold calls to thousands of prospective investors. The calls are made to persons unknown by the brokers. The names are drawn from sources such as telephone books and membership lists. The new rule addresses these high-pressure sales tactics in two ways.

First, the rule mandates a special account opening procedure. The brokers must make a written determination that penny stock purchases are suitable for the investor and must provide a written determination to the investor. In order to prepare these suitability determinations, the broker is required to obtain information concerning the customer's financial situation and investment needs.

The account approval procedure should alert the customer to whether the broker/dealer has misconstrued his financial situation and investment needs.

Second, the rule requires the broker/dealers to obtain these customers' written agreement to initial purchases of penny stocks. This written agreement provides the customer with an opportunity to make an investment decision outside the context of a pressured telephone conversation with the sales person.

As set out more fully in the Commission's written statement, rule 15c2-6 is designed to address penny stock sales practices effectively without unduly hampering legitimate small business capital formation that is so vital to the U.S. economy.

Accordingly, the Commission has built in exceptions and exclusions to avoid overly broad application.

With regard to customer arbitration, the Commission has an integral role in assuring that the SRO's operate a fair and efficient arbitration system, and assuring proper disclosure to investors.

Two Supreme Court decisions upholding the enforceability of predispute arbitration clauses and the rising cost of litigation in court have combined to make arbitration the primary forum for the resolution of investor grievances regarding violations of Federal securities laws.

Accordingly, the Commission and staff have placed special emphasis on oversight of securities arbitration programs by the self-regulatory organizations. In the year and a half prior to the Supreme Court's decision which upheld the enforceability of the arbitration agreements, the Commission staff carried out a broad-based review of SRO arbitration rules and forms to determine what improvements the arbitration process would need.

As a result of this review, Commission staff recommended to the securities industry conference on arbitration that the self-regulatory organization arbitration rules be amended to establish clear standards for who may serve as a public arbitrator; mandate thorough disclosure of arbitrator affiliations, codify and institute procedures to record and summarize cases; publicize the results of arbitrations; and codify and expand discovery procedures.

Each of these recommended reforms has been addressed in recent SRO rule filings.

Commission staff has also worked to provide investors with meaningful disclosure concerning predispute arbitration contracts before they enter into such agreements.

In July 1988, the Commission sent the SRO's a letter requesting that they examine issues surrounding their members' use of predispute arbitration clauses. In response, self-regulatory organizations adopted a uniform rule that requires broker/dealers who employed previous arbitration clauses to place immediately before the clause highlighted introductory language informing customers about both the existence and meaning of signing an arbitration contract.

The new arbitration clause rule also prohibits the self-regulatory organization members from having agreements with customers that limit or contradict the rules of any SRO, that limit the ability of customers to file any claim in arbitration or that limit the ability of the arbitrators to make any award.

Finally, the Commission staff also has monitored the self-regulatory organizations' staffing and resource levels to promote efficient administration of arbitration case load.

We believe that the SRO's are making reasonable efforts to administer their caseloads efficiently, notwithstanding the explosive growth in these caseloads.

The changes to case administration outlined in the Commission's written testimony contribute to a more timely processing of customer arbitrations. Further steps may be necessary and we will work with the SRO's as that is warranted.

In summary, the Commission and the self-regulatory organizations have taken substantial steps to improve the procedural fairness of self-regulatory organization arbitration and to ensure effective disclosure to investors of what rights they are waiving when they sign a predispute arbitration contract.

We are anxious to continue working with both the SRO's and the committee on ways to ensure continued investor confidence in the securities markets and in the arbitration forums available to resolve grievances with broker/dealers.

Thank you, Mr. Chairman.

[The complete statement of Richard G. Ketchum and Joseph I. Goldstein follow:]

TESTIMONY OF THE SECURITIES AND EXCHANGE COMMISSION
GIVEN BY RICHARD G. KETCHUM, DIRECTOR,
DIVISION OF MARKET REGULATION, AND
JOSEPH I. GOLDSTEIN, ASSOCIATE DIRECTOR,
DIVISION OF ENFORCEMENT,
BEFORE THE SUBCOMMITTEE ON SECURITIES
OF THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

CONCERNING ISSUES RELATED TO SMALL INVESTORS

February 8, 1990

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U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

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Testimony of the Securities and Exchange Commission
Given by Richard G. Ketchum, Director,
Division of Market Regulation, and
Joseph I. Goldstein, Associate Director,
Division of Enforcement,
Before the Subcommittee on Securities
of the Committee on Banking, Housing, and Urban Affairs
United States Senate

Concerning Issues Related To Small Investors

February 8, 1990

Chairman Dodd and Members of the Subcommittee:

The efficiency and liquidity of the securities markets depend on the participation of a wide range of investors, including small investors. Accordingly, the Commission appreciates the opportunity to present this testimony before the Subcommittee to discuss issues affecting small investors and, in particular, the Commission's efforts to combat penny stock fraud and initiatives regarding the securities arbitration process administered by the self-regulatory organizations ("SROs").

I. PENNY STOCK FRAUD

"Penny stocks" is a term used to refer to low-priced securities traded over-the-counter. While the majority of these securities are quoted in the "pink sheets" published daily by the National Quotation Bureau, many are quoted through the National Association of Securities Dealers Automated Quotation ("NASDAQ") system. Many penny stocks represent legitimate investment opportunities, and the market for these stocks is an honest one. However, experience has shown that many other penny stocks are used in fraudulent schemes which involve "shell" companies with no operating history, few employees, few assets, no legitimate prospects for business success, and markets that are manipulated to the benefit of the promoters of the companies and/or the market professionals involved.

In the early 1980's penny stock fraud was largely a regional problem, centered around a number of the Rocky Mountain states. The market boom of that time, coupled with frequent stories in the press of the fortunes that were being made by individuals who invested in the markets, helped set the stage for an enormous increase in the scope of penny stock fraud. By the late 1980's, what had once been a regional problem had spread, so that it was both national and international in its scope and in its disastrous consequences for the individual small investor.

There are a number of common signs of penny stock fraud.

- a market in securities of an issuer that is dominated and controlled by one or only a few broker-dealers that often are affiliated with the promoter or the issuer;
- a market manipulated upwards through pre-arranged matched purchases and sales;
- false or misleading press releases about the issuer's prospects;
- high pressure "boiler-room" sales practices, including unfounded price projections by inexperienced salespersons under the direction of professionals who specialize in penny stock solicitations;
- grossly inflated prices and undisclosed, excessive mark-ups by the broker-dealers involved;
- the dumping of securities at market peaks by the promoters or broker-dealers, who then move on to the next manipulation as stock prices collapse; and
- an innocent investing public left holding worthless stocks for which millions of dollars may have been paid.

Money is a powerful inducement to engage in fraudulent activity, and the profits to broker-dealers and their salespersons in penny stocks can be enormous. For example, over approximately a one-month period, two penny stock brokers monitored by one of the Commission's offices traded shares of two companies with a combined net worth of about $1 million. During this month, the brokers' profits in transactions involving these companies amounted to $3.5 million, more than three times the net worth of the two companies. In another case, a branch office of a penny stock firm made more than a $1 million profit in a single day through its activities in the penny stock market. Salespersons in some firms can reportedly make $5,000 per month after six months and $10,000 to $20,000 per month after one year's sales experience. Top salespersons at some penny stock firms have earned from $20,000 to $50,000 per month.

The abuses in the penny stock market have been reflected in the increased number of complaints received by the Commission from individual investors. In fiscal 1988, the Commission received 1,510 complaints involving penny stock firms (12.5% of all substantive broker-dealer complaints received by the Commission). In fiscal 1989, that figure rose to 3776 complaints (22% of all substantive broker-dealer complaints). Yet, the number of firms primarily engaged in the penny stock business is less than 5% of the registered broker-dealers in this country that do business with the public.

Individual investors who sustain stock losses are not the only victims of penny stock fraud. It is important to note that there are numerous legitimate issuers, including small rural banks, foreign issuers and start-up companies, whose low-priced securities are traded through the non-NASDAQ over-the-counter market. And, there are honest professionals in the securities business who provide market services for these issuers. In the public mind, these innocent and respectable issuers and professionals run the risk of being "tarred with the same brush" as those responsible for penny stock fraud, solely because they are involved in the same marketplace. Further, investors who are defrauded in penny stock scams and others who learn of such abuses may lose confidence in both the over-the-counter and other securities markets. The result may well be a tendency to avoid sound securities investments. That tendency could significantly harm the nation's capital formation process, particularly as it relates to legitimate small businesses, and, as a consequence, the nation's economy as a whole.

II. THE PENNY STOCK TASK FORCE

Recognizing the rapid spread of penny stock fraud, in October 1988 the Commission established the Penny Stock Task Force. The membership of the Task Force includes representatives from each of the Commission's Regional Offices and operating divisions. The Task Force identified four critical goals for the Commission in its efforts to combat penny stock fraud: (1) increased co-ordination and information-sharing with other federal, state and local regulators and prosecutors; (2) stepped-up enforcement activities, including criminal referrals when appropriate; (3) targeted regulatory solutions; and (4) investor education. As explained below, the Commission has made significant progress in each of these areas.

A. Increased Coordination and Information-Sharing

Efforts of the Task Force to increase coordination and information-sharing have included the holding of ten regional meetings around the country with federal and state regulators and prosecutors, including U.S. Attorneys' Offices and the Federal Bureau of Investigation ("FBI"), and with the National Association of Securities Dealers, Inc. ("NASD"). Commission staff also meet regularly with enforcement subgroups of the North American Securities Administrators Association ("NASAA"). The purpose of the meetings has been to share information and discuss strategies for dealing with penny stock fraud.

One development associated with the Commission's efforts has been the establishment of a penny stock task force in Florida. The Florida Penny Stock Task Force grew out of a meeting sponsored by the Commission's Miami Branch Office, and includes the State of Florida, the NASD, U.S. Attorneys' Offices, the FBI, the Internal Revenue Service ("IRS"), and other federal law enforcement authorities. This group meets on a quarterly basis in order to mobilize and coordinate more effectively the resources of the various member regulators and prosecutors. It serves as a model for ongoing state and federal cooperation.

The Commission also has conducted training sessions about securities fraud for staff from other federal and state agencies, with a view to enhancing, where appropriate, the number of civil and criminal cases brought by other authorities in the penny stock fraud area. On May 31 and June 1, 1989, the Commission hosted a two-day training program on securities and commodities fraud sponsored by the Justice Department's Securities and Commodities Fraud Working Group. The training program attracted over 150 participants, including representatives of NASAA, various U.S. Attorneys' Offices, the FBI, the IRS/Criminal Investigation Division, the Postal Inspection Service, the Customs Service, the NASD, the Commodity Futures Trading Commission, the National Association of State Attorney Generals, and prosecutors and regulators from eight foreign countries. A similar program, with over 200 participants, is underway this week in Denver, Colorado.

The Commission's staff also has conducted numerous training programs on penny stock fraud for FBI agents and Assistant U.S. Attorneys located around the country. These training programs are supplemented by the Commission's Annual Enforcement Training Program, which has traditionally been attended by representatives of other federal, state, and foreign governmental authorities, as well as the SROs.

The direct and indirect benefits from these meetings and training sessions are extremely important. The opportunity for face-to-face contact with our federal, self-regulatory, state, and foreign counterparts has proven invaluable in forging a stronger network of communication and cooperation among regulators and prosecutors.

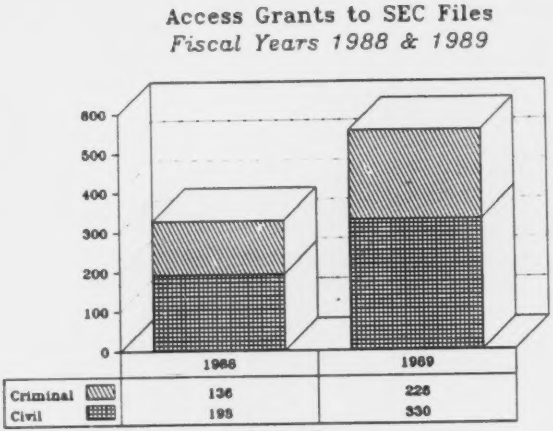

Figure 2

Success in increasing coordination and information-sharing with other governmental authorities is demonstrated in Figure 1. Figure 1 depicts the increase in the number of occasions on which the Commission granted access to its nonpublic files to civil and criminal authorities during fiscal year 1988 and fiscal year 1989, the first fiscal year of the Task Force's existence. Civil access grants increased from 193 to 330; criminal access grants increased from 136 to 226. While the dramatic increase is not fully and directly attributable to the efforts of the Penny Stock Task Force, it is indicative of the success of the Commission's efforts in this area.

These cooperative efforts will continue to expand as the Commission, in the course of its stepped-up enforcement activities, participates in joint investigations and examinations, refers cases, receives referrals, and shares information with other governmental authorities.

B. Stepped-up Enforcement Activities

A second critical goal of the Task Force is to increase, as appropriate, its enforcement actions in the penny stock fraud area and the number of criminal referrals.

Figure 2 shows the number of Commission penny stock enforcement proceedings instituted in fiscal years 1988 and 1989. Enforcement actions increased by 58%—from 43 to 68. The Task Force's success is also reflected by the 66% increase in access grants to the Commission's nonpublic files to criminal authorities in the last fiscal year.

SEC Penny Stock Enforcement Actions
Fiscal Years 1988 & 1989

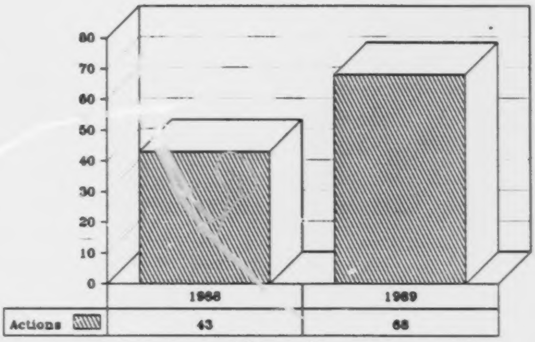

Figure 2

Too often, the individuals responsible for organizing, financing and executing stock manipulations in penny stocks are not deterred by the civil remedies that are currently available to the Commission. These civil remedies are viewed as part of the cost of doing business. Therefore, to deter penny stock fraud more effectively, the Commission is actively seeking to enlist the help of federal, state, and local criminal prosecutors.

The Commission's broker-dealer examination program has placed a great emphasis on examining broker-dealer firms engaged in a penny stock business since the Penny Stock Task Force was created. In the last 19 months, the Commission's regional offices have completed 197 examinations of penny stock broker-dealers. These examinations have uncovered serious violations involving excessive mark-ups, market manipulation, high-pressure boiler-room sales practice abuses, and misrepresentations concerning the business activities and financial condition of corporate issuers. Enforcement referrals have been made in 94 (47.7%) of the completed examinations, and an additional 20 examinations (10.2%) have been referred to the NASD for enforcement consideration. The Commission will coordinate its broker-dealer examination program with the NASD and continue its emphasis on examining penny stock firms in 1990, with particular focus on compliance by firms with new Rule 15c2-6.

State securities regulators and the NASD also are playing a vital role by bringing their own actions in the penny stock area. Notable in this regard are proceedings against numerous penny stock promoters, including state actions against Power Securities and NASD proceedings stemming from the Haas Securities failure.

Set forth below are descriptions of representative examples of the Commission's and the Department of Justice's recent penny stock fraud cases.

The Commission recently filed an injunctive action against Lifeline Healthcare Group, Ltd., officers and directors of Lifeline, a consultant to the company, four trusts, and Lifeline's corporate counsel.[1] Lifeline became a publicly-traded company in 1987, through a "stock swap" between a private company and a Denver-based public shell corporation. The Commission's complaint alleges that the defendants caused Lifeline to increase its outstanding shares from one million to four million, virtually all of the new shares being distributed to the defendants or their affiliates. The Commission has alleged that substantial quantities of Lifeline shares were placed in some of the defendants' secret trust accounts as a means to avoid reporting requirements, and that the defendants engaged in fraudulent promotional activities, including false oral representations to broker-dealers and the dissemination of numerous written promotional documents, intended to manipulate the price of Lifeline stock.

The Commission's complaint alleges that Lifeline filed false and misleading reports with the Commission and released additional false and misleading information to the public concerning the company's financial condition, business prospects, and the identities and holdings of several major shareholders. The complaint further alleges that the price of Lifeline's stock rose from less than $4 per share to more than $38 per share as a result of misinformation disseminated in the first half of 1989. The complaint also alleges that 40% of Lifeline's stock was held by the individual defendants, either directly or through the trusts, and that, contrary to the beneficial ownership reporting requirements of the federal securities laws, no statements had been filed with the Commission reflecting these ownership positions. The Commission has obtained a temporary restraining order and a freeze of assets in this case; in addition, a Special Master has been appointed by the court to act as a receiver.[2] The case remains in litigation.

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[1] *SEC v. Lifeline Healthcare Group, Ltd.*, Civ. Action No. 89 C-964 B, Litigation Release No. 12300 (Nov. 21, 1989).

Another significant penny stock enforcement action is a case filed in the Northern District of Illinois on August 3, 1989, against 16 defendants for various alleged violations of the federal securities laws.[3] The Commission's complaint alleges that Arnold Kimmes, Thomas Quinn, and Michael Wright, among others, were engaged in an international scheme to defraud the public in the registration, trading, and sale of two penny stocks, GSS Venture Capital Corporation ("GSS") and Max, Inc. ("Max"). The Commission has alleged that both GSS and Max were sham corporations from their inception and that the GSS scheme included figurehead officers and directors, placement of stock in nominee accounts, and stock price manipulations. The Commission's complaint alleges that over 2,000 U.S. and foreign investors from at least 45 countries lost in excess of $10 million through their investments in GSS securities. The Commission also alleges that Max had its price artificially inflated through a series of manipulations—its price rose from $.15 per unit (which consisted of one share of common stock and eight warrants) to over $4 per share alone, and in Europe to as much as $6.50 per share. Kimmes, Wright and Quinn have consented to the entry of preliminary injunctions against them.[4] In related criminal proceedings, Arnold Kimmes and his brother, Michael Kimmes (who is also a defendant in the Commission's action), pled guilty to charges based on the manipulation of penny stocks.[5]

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[2] *SEC v. Lifeline Healthcare Group, Ltd.*, Litigation Release No. 12312 (Dec. 5, 1989).

[3] *SEC v. Kimmes*, No. 89 C 5942 (N.D. Ill. filed Aug. 3, 1989), *summarized in* Litigation Release No. 12210 (Aug. 9, 1989).

[4] *SEC v. Kimmes*, No. 89 C 5942 (N.D. Ill.), *summarized in* Litigation Release No. 12249 (Sept. 13, 1989) (GSS and Max also enjoined, by default). Three other defendants, without admitting or denying the allegations against them, have consented (continued...)

In *SEC v. Goldcor, Inc.*,[6] the Commission sued a Delaware corporation whose principal business activities were purportedly taking place in Costa Rica and whose stock was being promoted heavily by brokerage firms in Salt Lake City, Utah, and Tulsa, Oklahoma. According to the Commission's complaint, Goldcor claimed that it had in operation a unique process to extract millions of dollars worth of gold from the black sands on Costa Rican beaches. The complaint alleged that this claim was a fabrication and that the company had never produced commercial quantities of gold from its Costa Rican operations. The complaint also alleged that Goldcor and its principal promoters sold unregistered stock and had issued numerous false and misleading statements about the company's operations and revenues in order to inflate the market for the stock. The court has entered orders that permanently enjoin Goldcor, preliminarily enjoin the other defendants (two individuals and a corporation), freeze certain of the defendants' assets, and appoint a receiver. The action is pending.

The Commission also has assisted criminal authorities in bringing major penny stock actions. In a criminal matter, the Commission staff investigating alleged manipulation of the stock of Memory Metals, Inc. provided data to the U.S. Attorney's Office for the Southern District of New York and assisted in its investigation, which led to the entry of indictments in March 1987 and

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4. (...continued)
to the entry of permanent injunctions. *See* Litigation Release Nos. 12290 (Oct. 3, 1989) and 12254 (Sept. 25, 1989).

[5] *U.S. v. Arnold Kimmes*, 89 Cr. 53 (PMP) (D. Nev.) (plea entered March 15, 1989), *summarized in* Litigation Release No. 12211 (August 9, 1989); *U.S. v. Michael Kimmes*, CR-5-89-219 (LDG) (D. Nev.), *summarized in* Litigation Release No. 12257 (Sept. 25, 1989).

[6] *SEC v. Goldcor, Inc.*, No. 88-612-CIV-ORL-18 (M.D. Fla. filed July 15, 1988), *summarized in* Litigation Release No. 11847 (Aug. 24, 1988).

November 1988 against two persons involved with the manipulation.[7] The defendants have both pled guilty. The court sentenced them to prison terms of two years and one-and-a-half years and permanently enjoined them not only from working at a brokerage firm, but also from buying or selling any security or commodity. The Commission also filed a civil action against Memory Metals.[8]

In another case, the Commission provided the U.S. Attorney for the District of New Jersey and New Jersey state authorities with information gathered in an investigation of fraudulent and deceptive trading practices engaged in by F.D. Roberts, a major, now-defunct penny stock broker-dealer. State and federal cooperation contributed to the criminal information later filed against an individual who was the firm's president, director of compliance and a member of the board, and against F.D. Roberts' former operations manager and its former regional sales manager, as well as the branch manager and five registered representatives at the firm's office in Boca Raton.[9] The U.S. Attorney for New Jersey estimates that as a result of its fraudulent and deceptive trading activities, F.D. Roberts allegedly realized gross trading profits of at least $67.2 million in a three-year period ending in 1988, not including profits earned by illegal security sales in nominee accounts. The Commission also has brought an action seeking injunctive and other equitable relief against F.D. Roberts and 13 other parties alleging that the broker-dealer, together with others, manipulated the stock of Hughes Capital Corporation.[10] The matter remains in litigation.

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[7] *U.S. v. Hyman*, Nos. 87 Cr. 212 (CSH) and 88 Cr. 742 (CSH) (S.D.N.Y. sentence entered Oct. 6, 1988), and 88 Cr. Misc. (LBS) (S.D.N.Y. sentence entered Nov. 2, 1988); *U.S. v. Rodman*, 87 Cr. 292 (MEL) (S.D.N.Y. sentence entered Feb. 16, 1989).

[8] *See SEC v. Memory Metals*, Civ. Action No. B-89-089 (WWE), Litigation Release No. 12004 (February 22, 1989).

[9] *U.S. v. Kanoff*, 89 Cr. 351 (D.N.J.), *summarized in* Litigation Release No. 12283 (Oct. 27, 1989); *U.S. v. Siesser*, 89 Cr. 184 (D.N.J.), *summarized in* Litigation Release No. 12166 (July 17, 1989), 44 SEC Docket 51; *U.S. v. Eisen*, 89 Cr. 185 (D.N.J.); *U.S. v. Zacharewicz*, 89 Cr. 349 (D.N.J.), *summarized in* Litigation Release No. 12285 (Oct. 27, 1989); *U.S. v. Lendrum*, 89 Cr. 348 (D.N.J.), *summarized in* Litigation Release No. 12284 (Oct. 27, 1989); *U.S. v. Conte*, 89 Cr. 298 (D.N.J.), *summarized in* Litigation Release No. 12282 (Oct. 27, 1989); *U.S. v. Humphrey*, 89 Cr. 186 (D.N.J.); *U.S. v. Rutherford*, 89 Cr. 187 (D.N.J.); *U.S. v. Napolitan*, 89 Cr. 222 (D.N.J.).

Another notable instance of close cooperation was the technical assistance provided by the Commission's Salt Lake City and Denver offices in the course of the FBI's recent penny stock undercover operation in Salt Lake City. Undercover FBI agents let it be known that they were interested in purchasing a shell corporation into which they could then merge a private company for manipulative purposes. The shell company they ultimately purchased was Protecto Industries, Inc. The purported "scheme" was to involve listing the public company's stock in the pink sheets, followed by an upward manipulation of the price.

As a result of the Protecto operation, the U.S. Attorney in Salt Lake City obtained a 36-count indictment against three defendants and criminal informations against seven other individuals in January 1989, charging them with criminal conspiracy, securities fraud, violation of the registration provisions and wire fraud.[11] Defendants included a promoter who allegedly provided a fraudulently "revived" pre-1933 shell corporation, an accountant who created fictitious financial statements, transfer agents and three promoters.[12] In a related civil action, the Commission obtained consent injunctions against several of the individuals named in the criminal actions.[13] Also, in administrative

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[10] *SEC v. Hughes Capital Corporation, F.D. Roberts Securities, Inc. et al.*, No. 88-5238 (D.N.J. filed Dec. 13, 1988), *summarized in* Litigation Release No. 11939 (Dec. 13, 1989); *see also, SEC v. Tucker*, Civ. Action No. 89-6974-CIV-Gonzalez (S.D. Fla., filed Nov. 20, 1989), *summarized in* Litigation Release No. 12307 (Nov. 27, 1989).

[11] The defendants against whom informations were entered pled guilty at the time charges were filed, and five of these defendants have been sentenced. One of the indicted defendants, a transfer agent employee, has since entered a guilty plea and been sentenced. *U.S. v. LaCasto*, Cr. Act. No. 89-CR-0015G (D.Utah), *summarized in* Litigation Release No. 12263 (Oct. 3, 1989).

[12] *U.S. v. Gleave*, No. 89-CR-015G (D. Utah) (indictment entered Jan. 18, 1989), *summarized in* Litigation Release 12024 (Mar. 8, 1989), 43 SEC Docket 108.

[13] *SEC v. Timothy*, Civ. Action No. 89-C-535-J (D. Utah), *summarized in* Litigation Release No. 12145 (June 29, 1989); *SEC v. Lemmon*, Civ. Action No. 89-C-270-S (D. Utah), *summarized in* Litigation Release No. 12076 (May 1, 1989); *SEC v. Hansen*, Civ.

(continued...)

proceedings pursuant to Rule 2(e) of the Commission's Rules of Practice against the accountant who prepared the Protecto financial statements, the respondent consented, without admitting or denying the Commission's allegations, to a permanent bar from practicing or appearing before the Commission.[14]

C. Targeted Regulatory Solutions

A third goal of the Task Force involves the review of the Commission's regulatory structure and the consideration of regulations targeting penny stock fraud. A broad range of ideas has been discussed by the Task Force as well as with representatives from various state and federal agencies. As a result of these discussions, the Commission recently took two regulatory initiatives—the adoption of Rule 15c2-6 and the proposal of amendments to Rule 15c2-11. Additionally, last year the NASD adopted Schedule H to its by-laws.

1. Rule 15c2-6

Rule 15c2-6 requires broker-dealers to approve each customer's account for transactions in penny stocks by making and providing to the customer prior to the initial purchase a written determination that penny stocks are suitable for the customer. In addition, the broker-dealer must obtain the customer's written agreement to initial penny stock purchases. This major regulatory initiative to combat fraudulent sales tactics by penny stock broker-dealers was adopted by the Commission in August 1989 and went into effect on January 1, 1990. Rule 15c2-6 should prove to be an effective deterrent of sales practice abuses involving penny stocks, as well as a useful new enforcement tool against broker-dealers who engage in such misconduct.

The Commission has found that the sales tactics employed by fraudulent penny stock broker-dealers often result in small investors being the primary victims of penny stock fraud. Most of the sales practice abuses involving penny

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13. (...continued)
Action No. 89-C-314-S (D. Utah), *summarized in* Litigation Release No. 12073 (Apr. 27, 1989).

[14] *In the Matter of Marvin D. Hanley*, Exchange Act Release No. 27039 (July 17, 1989).

stocks are conducted over the telephone by broker-dealers engaging in "boiler-room" operations. Improved communications technology has enabled an increasing number of these broker-dealers to engage in high pressure sales campaigns on a nationwide basis.

An essential aspect of a boiler-room operation is the use of numerous salespersons making hundreds of high pressure cold calls each day to generate sales of penny stocks to new customers. Cold calls are telephone calls made to persons who are not previously known to the broker-dealer, but whose names have been drawn from sources such as a telephone directory or membership list. Consequently, many of the persons called have little investment experience and limited financial resources. Moreover, penny stock salespersons are trained in high pressure sales tactics designed to elicit a buy decision during the course of a telephone call and typically are compensated solely by commissions on sales. Because many of the persons called are inexperienced investors, they are particularly vulnerable to deceptive sales pitches promising high profits made by salespersons willing to disregard the unsuitability of a security for the purchaser.

Rule 15c2-6 should help prevent penny stock fraud by imposing objective and readily reviewable requirements that govern the process by which new customers are induced to purchase penny stocks. The account approval procedure mandated by Rule 15c2-6 reinforces broker-dealers' suitability obligations, which historically have been an important standard constraining indiscriminate, high pressure sales tactics.[15] The broker-dealer is required to obtain information concerning the customer's financial situation and investment needs, make a written determination that penny stocks are a suitable investment for the customer, provide this determination to the customer, and obtain a manually signed and dated copy of the determination from the customer. The customer therefore will have an opportunity to decide whether the broker-dealer has made a good faith attempt to consider the customer's financial situation and investment needs. In addition, the written suitability document significantly enhances the ability of regulatory authorities to review whether the broker-dealer has made a suitability determination appropriate for the particular customer.

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[15] *See generally* Report of Special Study of Securities Markets of the SEC (1963), *reprinted in* H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963), pt. 1 at 237-40, 302-30.

Rule 15c2-6 also requires broker-dealers to obtain each customer's written agreement to the customer's initial purchases of penny stocks. This written agreement requirement provides the customer with an opportunity to make an investment decision outside the context of a pressured telephone conversation with a salesperson. Boiler-room salespersons realize the importance of making a sale while on the telephone and use high pressure tactics to close the sale. The written agreement requirement is intended to remove this pressure for an immediate decision. In addition, the written agreement provides objective evidence of the customer's assent to a penny stock purchase, thereby helping prevent unauthorized transactions in the customer's account.

The Commission recognizes that certain broker-dealers might choose to ignore the requirements of Rule 15c2-6. The rule therefore requires records to be kept that will indicate broker-dealer compliance with each of its provisions. This documentation will enable regulatory authorities to review a broker-dealer's compliance with the rule and will provide the basis for simple and direct enforcement actions against broker-dealers that fail to comply.

Rule 15c2-6 is designed to address fraudulent penny stock sales practices effectively without unduly hampering the legitimate small business capital formation that is so vital to the U.S. economy.[16] Similarly, the impact of the rule on legitimate broker-dealers should be minimal.

The rule is focussed on situations presenting the greatest opportunity for fraudulent sales practice activity and where existing regulatory protections have proven least effective.[17] A number of exclusions and exceptions were developed to avoid overly broad application of the rule. For example, the application of the rule is limited to "designated securities," which generally are defined as non-NASDAQ over-the-counter equity securities whose issuers have less than $2 million in net tangible assets.

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[16] The Commission has taken numerous actions to facilitate the issuance of securities by small businesses. For example, the Commission has promulgated Regulation D, 17 CFR 230.501 - 230.508, under the Securities Act of 1933, 15 U.S.C. 77a-77aa ("Securities Act"), which provides exemptions from registration that are helpful to small businesses. The Commission also has adopted Form S-18, which provides a simplified registration process for issuers raising less than $7.5 million. *See* Securities Act Release No. 6049 (April 3, 1979), 44 FR 21567. Furthermore, the Commission has increased the asset level that triggers reporting requirements under section 12 of the Exchange Act from $1 million to $5 million. *See* 17 CFR 240.12g-1. Each of these initiatives was intended to lower the costs and simplify the process of small business capital formation. In addition, the Commission annually holds the Government-Business Forum on Small Business Capital Formation in order to obtain a wide range of views on initiatives that would facilitate small business capital formation.

Another important provision of Rule 15c2-6 designed to facilitate capital formation by small businesses is the exemption for transactions in which the price of the security is five dollars or more. Small issuers therefore can avoid the rule by adjusting their capital structures and setting the offering prices for their securities at five dollars or more.[18]

Exemptions also are provided in Rule 15c2-6 for transactions involving purchasers who are less likely to be subject to sales practice abuses, such as established customers of the broker-dealer and accredited investors. An established customer is defined in the rule as a customer who has had an account with the broker-dealer for more than a year or who has purchased three separate designated securities from the broker-dealer. Accredited

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17. In weighing the effect of Rule 15c2-6 on small business capital formation, the extent to which the public securities markets provide capital to small businesses must be considered. The U.S. Small Business Administration has indicated that approximately 75% of the capital for small businesses is provided by the operators of the businesses and their families and by informal investors — those who invest in small businesses without the intermediation of financial professionals and who therefore are not covered by Rule 15c2-6. The other 25% of capital for small businesses is provided by public investors and professional venture capitalists. *See* Text of Remarks of Frank S. Swain, Chief Counsel for Advocacy, U.S. Small Business Administration, in U.S. Securities and Exchange Commission, Final Report of the Seventh Annual Government-Business Forum on Small Business Capital Formation, Appendix F (1989).

18. This approach is consistent with the Uniform Limited Offering Registration ("ULOR") project developed by the State Regulation of Securities Committee of the American Bar Association. ULOR is intended to provide a streamlined procedure for small businesses raising less than $1 million in offerings exempt from Securities Act registration under Rule 504 of Regulation D, 17 CFR 230.504. In order to prevent abuses in the secondary market for securities issued pursuant to ULOR, issuers cannot use ULOR for offerings in which the price of common stock is less than five dollars. For a description of the purposes and requirements of ULOR, see J. Harris, S. Keller, G. Stakias & M. Liles, *Financing the "American Dream" — Small Business and the ULOR Project*, 43 Bus. Law. 757, 762-63 (1988).

investors generally include institutional investors and individuals with annual net income in excess of $200,000 or a net worth in excess of $1 million. By exempting transactions that involve less likelihood of boiler-room sales practices, legitimate broker-dealers are able to conduct transactions in small business securities with their existing customers without the necessity of meeting the rule's additional sales practice requirements.

The Commission believes that Rule 15c2-6 is a well-balanced response to penny stock fraud. Because Rule 15c2-6 has been in effect for only a short period of time, it is too soon to evaluate the extent to which the rule has deterred fraudulent penny stock sales practices or the rule's effect on small businesses capital formation. The Commission staff is monitoring these areas closely, however, and the Commission intends to enforce strict compliance with the rule's requirements. Moreover, the release adopting Rule 15c2-6 specifically requested comment on the rule after it had been in effect for a period of time and its impact could be ascertained through practical experience. If the rule fails to achieve its goal of reducing fraud without unduly hampering small business capital formation, the Commission will consider appropriate modifications of the rule.

2. Rule 15c2-11

In another action designed to combat fraud and manipulation in the market for penny stocks, the Commission in September 1989 proposed amendments to Exchange Act Rule 15c2-11 that would increase the responsibilities of broker-dealers who make markets in penny stocks.[19] Rule 15c2-11 governs the submission and publication of quotations by broker-dealers for certain over-the-counter securities that are not traded on the NASDAQ system. The rule requires such broker-dealers to obtain specified information concerning a security before initiating or resuming a quotation in a quotation medium, such as the pink sheets.

The proposed amendments to Rule 15c2-11 would revise the rule by requiring a broker-dealer to review the information about the security specified in the rule and to have a reasonable basis to believe that the information is true and accurate and obtained from reliable sources. The proposal also would require a broker-dealer initiating or resuming quotations in an issuer's securities to have in its records a copy of any trading suspension order, or Exchange Act release announcing a trading suspension, issued by the Commission with respect to any of the issuer's securities during the preceding year, and to review the other required information in its records in light of information contained in that order or release.

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[19] Securities Exchange Act Release No. 27247 (September 14, 1989), 54 FR 39194. In addition, the NASD has filed a proposed rule change with the Commission that would intensify NASD monitoring of its members' compliance with Rule 15c2-11. The NASD proposal is discussed more fully below.

These proposals would increase the likelihood that broker-dealers making markets in penny stocks have an adequate basis for their quotations. Moreover, the proposals would reduce the possibility that legitimate market makers unwittingly may facilitate a scheme by others to manipulate the market for a penny stock. The Commission staff currently is reviewing the public comments on the proposed amendments to Rule 15c2-11 and will make its recommendations to the Commission as soon as possible.

3. NASD Initiatives

The NASD has undertaken several important regulatory initiatives to combat fraud and manipulation in the non-NASDAQ over-the-counter market. These initiatives include Schedule H transaction reporting requirements, a proposed OTC Bulletin Board Display Service, and proposed Rule 15c2-11 filing requirements.

In May 1988, the Commission approved the NASD's adoption of new Schedule H to its By-Laws,[20] which increases substantially the information available regarding the non-NASDAQ over-the-counter market. Schedule H requires each NASD member to report price and volume information on its principal transactions in any non-NASDAQ over-the-counter equity security on any day that its aggregate purchases or sales of that security exceed either 50,000 shares or $10,000. Prior to the adoption of Schedule H, it was very difficult for regulatory authorities to obtain reliable and timely information on trading in non-NASDAQ over-the-counter securities. The information provided under Schedule H will be of great value in developing and bringing enforcement actions concerning manipulative trading in such securities.

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[20] NASD Schedules to the By-Laws, Schedule H, *NASD Manual* (CCH) ¶¶1932-33.

The NASD also has filed a proposed rule change with the Commission to establish the OTC Bulletin Board Display Service ("OTC Bulletin Board").[21] The OTC Bulletin Board would permit NASD members to enter, update, and retrieve quotation information on a real-time basis in non-NASDAQ over-the-counter securities. Currently, quotation information in these securities is available primarily through print media, such as the pink sheets, and therefore may not be timely or accurate. The NASD filing indicates that, by making quotation information available on a real-time basis, the OTC Bulletin Board should enhance the efficiency of pricing and promote competition among market makers in the non-NASDAQ over-the-counter market.

In another development that would intensify NASD monitoring of compliance with Rule 15c2-11, the NASD has filed a proposed rule change with the Commission to amend Schedule H of its By-Laws.[22] The proposed amendment would require NASD members to file with the NASD materials that indicate their compliance with Rule 15c2-11 at least three days prior to initiating or resuming a quotation in a non-NASDAQ over-the-counter security. If the NASD determined that a firm had failed to demonstrate sufficiently its compliance with the rule, the NASD would notify the firm of the determination and the basis for it. Until the firm demonstrated full compliance with the rule, the NASD would deny the firm access to the OTC Bulletin Board. Moreover, if the firm proceeded to publish a quotation in any other quotation medium without fully complying with the rule, the NASD could take formal disciplinary action against the firm.

The Commission staff currently is reviewing the OTC Bulletin Board proposal and the Rule 15c2-11 filing proposal and intends to take further action on the proposals as soon as possible.

D. Investor Education

The last of the Task Force's critical goals is increasing investor awareness of how to recognize and avoid fraudulent penny stock schemes. The Task Force has adopted two principal means of achieving this goal—preparing and distributing to the public educational bulletins that warn of concerns about penny stocks and encouraging media coverage of the efforts and focus of the Task Force.

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[21] Securities Exchange Act Release No. 25949 (July 28, 1988), 53 FR 29096.

[22] File No. SR-NASD-90-2 (January 8, 1990). The proposal is expected soon to be published for public comment in the Federal Register.

The Task Force has written and distributed three investor bulletins on penny stock fraud.

> The first—*Beware of Penny Stock Fraud!*—provides basic information about penny stocks, describes warning signs of penny stock fraud, and recommends steps investors should consider before investing in penny stocks.
>
> The second—*Penny Stock Telephone Fraud*—gives examples of the types of tactics sometimes used in high-pressure telephone sales campaigns. It also recommends steps investors should consider to reduce their chances of being victimized by penny stock fraud.
>
> The third—*New Penny Stock Cold Calling Rule*—announced the Commission's adoption of Rule 15c2-6, described how that rule is designed to help those who are solicited to invest in penny stocks, and provided an overview of the workings of the new rule.

These bulletins have been published as part of the Commission's "Information for Investors" series. Their existence has been announced by way of Commission releases that are distributed to the press and they are routinely being sent to persons who write or call the Commission with complaints relating to penny stock fraud. In addition, the Commission's regional administrators have sought the assistance of banks and utility companies in their areas, asking them to include the bulletins with their monthly billing or account statements. For example, our Miami Branch Office has arranged for over 1.8 million copies of the Commission's *Beware of Penny Stock Fraud!* bulletin to be distributed by banks, savings and loan associations, and major utility companies in Florida. The Florida Division of Securities has prepared a Spanish version for distribution to the public.

We have also made extra efforts to help assure that the radio, television, and print media are aware of the mission and actions of the Task Force, including the penny stock actions of state, federal, foreign, and self-regulatory authorities. The Commission believes very strongly in the educational impact resulting, for example, from an individual investor reading about the dangers of penny stock fraud on the front page of the local newspaper. We therefore have held numerous press conferences, encouraged and participated in interviews, and undertaken wide distribution of announcements—all with a particular emphasis upon ensuring that actions are reported not only by the national media, but also by the regional and local media. The results have been gratifying. Issues regarding penny stocks are now routinely deemed to be worthy of the time and attention of the media. There has been strong media interest in the Task Force's activities.

The Task Force's efforts to achieve the goal of improving investor education regarding penny stock fraud will continue. The goal is based upon a simple premise: regardless of the efforts of prosecutors and regulators, the first and most effective line of defense against penny stock fraud is an educated investor.

E. Indicators of Success

Due to the nature of the conduct that is the subject of any antifraud enforcement program, it is normally impossible to obtain empirical, overall data from which definite conclusions of the success of the program may be drawn with confidence. The Commission's penny stock program is no different. There is, however, a statistical source of information that provides significant indications that the Penny Stock Task Force is accomplishing its mission.

Pursuant to Commission Rule 17a-5 under the Securities Exchange Act of 1934, broker-dealers periodically file with the SROs FOCUS (Financial and Operational Combined Uniform Single) Reports. FOCUS Report data are financial and operational in nature. Selected data from the FOCUS Reports of broker-dealers engaged in the penny stock market tend to show a significant reaction to the efforts of the Penny Stock Task Force. These data, for the seven quarters ending September 30, 1989 (the most recent quarterly information available), are depicted below.

Figure 3 shows the significant decline that has occurred in the number of all broker-dealers regularly engaged in the penny stock market. From a peak of 352 at the end of June 1988, the latest number shows 303 such broker-dealers.

Penny Stock Broker–Dealers
Seven Quarters Ending
September 30, 1989

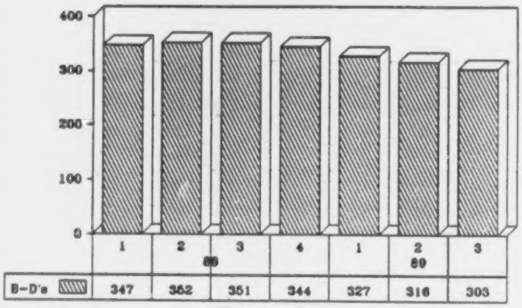

Figure 3

In addition to the information shown in Figure 3, those broker-dealers who clear transactions[23] or carry customer accounts[24] are required to file significant additional information on Part II of the FOCUS Report. Approximately 20% of all penny stock broker-dealers are required to file Part II of the FOCUS report. Additional information on Part II includes compensation of registered representatives, total numbers of sales staff, and the number of "tickets" per month (*i.e.*, orders to buy or sell securities). Figures 4-6, set forth below, show this information.

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[23] Clearing is the process of completing a trade, including the payment of monies or receipt of securities for customers or for other broker-dealers.

[24] A broker-dealer who "carries customer accounts" is responsible for holding customer funds and securities.

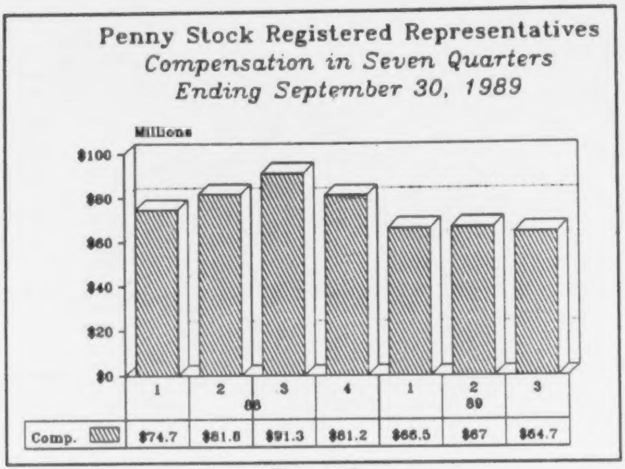


Figure 4

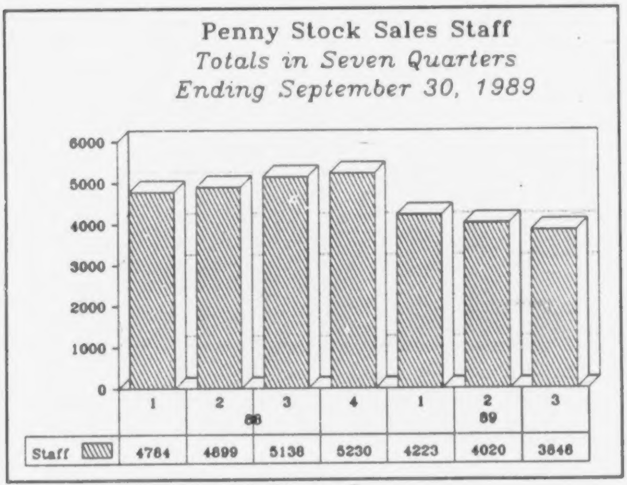
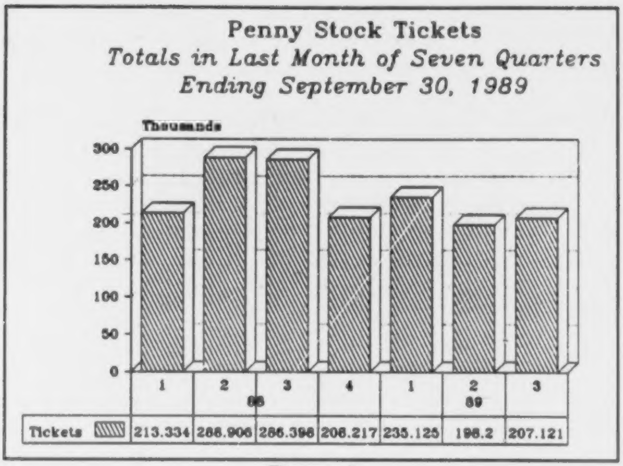


Figure 5



Penny Stock Tickets
Totals in Last Month of Seven Quarters Ending September 30, 1989

Figure 6

In summary, for Part II FOCUS Report filing firms, the compensation of registered representatives employed by penny stock broker-dealers declined from a peak of $91.3 million in the third quarter of 1988 to $64.7 million in the third quarter of 1989. Similarly, the sales force of penny stock broker-dealers declined from its peak of 5,230 in the fourth quarter of 1988 to 3,848 in the third quarter of 1989 and the number of tickets declined from 288,906 in the second quarter of 1988 to 207,121 in the third quarter of 1989 (the latter amount shows a slight increase over the second quarter 1989 amount—198,200). The respective percentage decreases, from peak to the most current quarter, in the amount of registered representative compensation and the number of sales staff and tickets are 29%, 26% and 28%.

III. FINANCIAL INSTITUTION SALES

Another area of concern affecting small investors is the sale of securities issued by an insured financial institution or its affiliate by employees of such an institution or affiliate. The Commission is concerned that the sale of these securities, particularly where the securities are sold on the premises of the insured institution, may involve substantial risks that investors could be confused regarding the entity that is the issuer of the securities and whether the securities are insured obligations of the financial institution. Small investors are especially vulnerable to this confusion because they generally are the type of investors solicited on the premises of a financial institution.

Public attention recently has been focused on the extraordinary number of thrift failures occurring during recent years and on the associated cost of these failures. The House Committee on Banking, Finance, and Urban Affairs is holding hearings, at which Chairman Breeden testified in November, that deal with this issue. Some of attention concerning the thrift crisis has focused on the sale of financial institution securities to depositors.

The system of federal deposit insurance and the extensive regulatory structure applicable to insured institutions are designed to create public confidence in the nation's financial institutions. The trust that individuals are encouraged to place in these institutions and in the federal deposit insurance system creates a high likelihood that customers of these institutions may mistakenly believe that they are making an insured deposit rather than purchasing an uninsured security. This risk is particularly acute when uninsured financial instruments, such as subordinated debentures, are sold on the premises of the financial institution.

The Commission is considering various regulatory measures that may be necessary and appropriate to address these issues.[25] The Division of Corporation Finance has requested bank holding companies and savings and loan holding companies to provide it with information regarding the extent to which sales of any securities issued by the holding companies or any of their affiliates, including uninsured securities issued by a subsidiary that is an insured institution, were made on the premises of the insured institution or using employees of an insured institution over the past five years. The Commission also recently established a special unit within the Division of Enforcement to address securities law violations by financial institutions and their affiliates.

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25. Legislation has been introduced in the House of Representatives relating to this issue. H.R. 3721, introduced by Rep. McMillan, and H.R. 3777, introduced by Rep. Schumer, would amend the Federal Deposit Insurance Act, 12 U.S.C. 1828, to prohibit or limit the sale of the securities of financial institutions or their affiliates in public areas of the institutions.

IV. THE SECURITIES LAW ENFORCEMENT REMEDIES ACT AND THE INTERNATIONAL SECURITIES ENFORCEMENT COOPERATION ACT

In 1989, the Commission sent to Congress two legislative initiatives which, although not specifically targeted toward the penny stock fraud problem, would provide the Commission with greater enforcement capability for use in attacking penny stock fraud. These proposals have been introduced as H.R. 975 and S. 647, the Securities Law Enforcement Remedies Act of 1989, and H.R. 1396 and S. 646, the International Securities Enforcement Cooperation Act of 1989. The Senate bills were jointly introduced by Chairman Dodd and Senator Heinz. The Senate has passed H.R. 1396; it is currently pending before the House.

Affirmative action by the Congress on both bills would enhance the Commission's enforcement ability in several important respects. The Securities Law Enforcement Remedies Act would alter the economic consequences of securities law violations, and would thereby deter violations for financial gain and violations by recidivists who have not been deterred by prior sanctions imposed upon them. Money penalties would give the courts and the Commission greater flexibility to tailor a remedy to the gravity of the violation. In addition, the Commission recently proposed revisions to the bill. The revisions would add cease-and-desist authority to the Commission's enforcement powers. That authority would make the Commission's enforcement process more efficient, flexible, precise, and fair, and enable the Commission to provide needed protection to the investing public with increased speed. Express judicial authority to impose corporate bars and suspensions in cases of violations of Section 17(a)(1) of the Securities Act or Section 10(b) of the Exchange Act, which also have been proposed as part of the legislation,[26] would resolve any doubts about the propriety of this remedy. This remedy has been obtained in Commission injunctive actions settled by consent and in at least one litigated case.[27]

The International Securities Enforcement Cooperation Act would permit greater flexibility in responding to problems incidental to the increasing internationalization of the securities markets. Among other things, the Act would permit the Commission and the SROs to deny registration to persons who have been sanctioned by foreign regulators, thereby preventing those individuals from "setting up shop" in the United States after their fraudulent conduct has been uncovered elsewhere. Enactment of this bill would also further international enforcement cooperation, which has proven essential to the attainment of the Penny Stock Task Force's goals. In particular, the bill would exempt confidential documents received from foreign authorities from disclosure requirements under the Freedom of Information Act ("FOIA"). Conflicts between the confidentiality requirements of foreign nondisclosure laws and the FOIA have been an impediment to the receipt of information from, and negotiation of memoranda of understanding with, foreign authorities. In addition, the Act would make explicit the Commission's authority to enact rules allowing it to provide nonpublic documents and other information to domestic and foreign authorities.

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[26] Commissioner Fleischman has concurred in this proposal but has not concurred in the other legislative recommendations referred to in this paragraph.

[27] *See SEC v. Techniculture, Inc.*, [1973-74 Transfer Binder] Fed. Sec. L. Rep. ¶ 94,501 (CCH) (D. Ariz. 1974).

V. ARBITRATION

The securities arbitration process administered by the SROs provides an opportunity for public investors to recover damages when they have been treated unfairly by their broker-dealers. During the past several years, the Commission and its staff have placed special emphasis on oversight of the securities arbitration programs of the SROs. Recently, those oversight efforts culminated in the Commission's approval on May 10, 1989, of major reforms to the SRO arbitration rules.

Arbitration of securities disputes has greatly increased over the past five years. Two Supreme Court decisions upholding the enforceability of predispute arbitration clauses[28] and the rising costs of court litigation have combined to make arbitration the primary forum for the resolution of investor grievances with broker-dealers, including the enforcement of investors' rights under the federal securities laws. As the federal agency responsible for the maintenance of fair and orderly markets and for the protection of investors, the Commission has an integral role in assuring the operation of an effective SRO arbitration system and in assuring that investors who agree to arbitrate disputes are well informed prior to doing so. The Commission's active oversight role, exercised pursuant to its authority and responsibility under the Securities Exchange Act, requires the SROs to provide fair and affordable arbitration forums, and commit sufficient resources to meet investor demands for access to the SROs' arbitration facilities.

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[28] "Predispute arbitration clause" refers to an agreement, entered into at the time a customer first opens an account with a broker-dealer, to settle all controversies between the customer and the broker-dealer by arbitration.

The Commission staff has worked through the Securities Industry Conference on Arbitration ("SICA") to improve the fairness and efficiency of securities arbitration and to provide investors with meaningful disclosure concerning predispute arbitration contracts before they enter into such agreements. Likewise, the Commission staff has monitored SRO staffing and resource levels to promote efficient administration of arbitration caseloads. As set out more fully in the statement, there remain areas where further improvements can be made. These areas are currently being addressed, on the recommendation of the Commission's staff and others, by the SROs and SICA. However, the Commission believes that current SRO arbitration procedures provide the opportunity for the fair resolution of disputes between investors and their broker-dealers.

A. Commission Oversight of Securities Arbitration

In *Shearson/American Express, Inc. v. McMahon*[29] the Supreme Court held that an account agreement requiring arbitration of customer claims under the Securities Exchange Act of 1934 did not violate the antiwaiver provision of that Act,[30] and was therefore enforceable[31] under the Federal Arbitration Act.[32] In the *McMahon* decision, the Supreme Court expressly relied upon the existence of the "broad authority" of the Securities and Exchange Commission to "oversee and regulate the rules adopted by the SROs relating to customer disputes ..." in reaching the conclusion that a predispute arbitration agreement does not result in a waiver of investor protections provided by the Exchange Act.[33] The Court reaffirmed the importance of Commission oversight of SRO arbitration rules last term in *Rodriguez de Quijas v. Shearson/American Express, Inc.*,[34] which upheld the validity of predispute arbitration clauses concerning customer claims against broker-dealers brought under the Securities Act of 1933.

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[29] 482 U.S. 220 (1987).

[30] 15 U.S.C § 78cc.

[31] In 1985, the Court, in *Dean Witter Reynolds v. Byrd*, 470 U.S. 213 (1985), upheld the validity of predispute arbitration clauses as applied to state law claims and rejected the "intertwining doctrine." The intertwining doctrine had permitted federal district courts to assume jurisdiction of state law claims that were factually inextricable from the then non-arbitrable federal securities law claims, rather than refer those claims to arbitration pursuant to predispute arbitration clauses.

[32] 9 U.S.C. § 1 *et seq.*

In the year and a half prior to the *McMahon* decision, the Commission staff carried out a broad based review of SRO arbitration rules and the operation of those rules at individual SRO arbitration forums to determine what improvements might be needed. As a result of its review, the staff developed a number of recommendations. These recommendations for reform were summarized in a September 1987 letter from the Commission to SICA[35] setting out the Commission's views on the need for changes to SICA's Uniform Code of Arbitration ("Uniform Code").[36] Following receipt of the Commission's letter, SICA and its subcommittees met regularly in order to draft rules that met the Commission's concerns. The Commission staff also had frequent discussions with SICA, as well as with individual SRO staff members and committees, in order to develop effective new arbitration rules.

In May 1989, the reform process initiated by the staff's review culminated in the Commission's approval of new SRO arbitration rules that improve virtually all significant aspects of the arbitration process. For example, the

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33. 482 U.S 220, 233-234.

34. 109 S.Ct. 1917 (1989) at 1921.

35. SICA was formed by the securities industry in 1977 to review then existing arbitration procedures. The industry formed SICA at the Commission's invitation as an alternative to the institution of the Commission's own proposals to establish a system for the resolution of disputes between broker-dealers and their customers. SICA is comprised of a representative of each SRO, a representative of the securities industry, and four representatives of the public.

36. The Uniform Code, developed in the 1970's to establish a uniform body of rules for SRO-sponsored arbitration, has been adopted with few changes by individual SROs: the National Association of Securities Dealers, the Municipal Securities Rulemaking Board, and each of the national securities exchanges that administers an arbitration system for the resolution of disputes between investors and broker-dealers.

revised rules address such key issues as who may serve as arbitrators, public availability of the results of arbitrations, prehearing discovery of information, and other issues important to investor confidence in arbitration as a means for resolving disputes with the brokerage community. In addition, the new rules also prescribe specific disclosure requirements for customer account agreements that include predispute arbitration clauses and prohibit the use of such clauses to curtail substantive rights that would otherwise be available in a judicial forum.

The Commission's September 1987 recommendations to SICA were directed at improving both the procedural fairness and efficiency of SRO arbitration programs. Specifically, the Commission asked SICA to amend the arbitration rules to: establish clear standards for who may serve as a public arbitrator; mandate thorough disclosure of arbitrator affiliations; codify and institute procedures to record and summarize cases; publicize the results of arbitrations; and codify and expand discovery procedures. Each of these recommended reforms has been addressed through the recent SRO rule changes.[37]

The key reform adopted following the Commission's 1987 initiative is a revised set of qualifications for who may serve on arbitration panels as a public arbitrator.[38] For example, the rules now exclude from the public arbitrator pool persons who are retired from the securities industry and professionals, such as lawyers and accountants, who regularly service the securities industry. Family members of securities industry personnel have also now been excluded from the public arbitrator pool. These changes address the potential for and the appearance of arbitrator bias by clarifying the distinctions between the public and securities arbitrator pools. The new qualifications for public arbitrators represent a significant departure from past practice and should promote impartial and knowledgeable decisions in the arbitration of disputes between investors and broker-dealers.

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[37] These rule changes are discussed in greater detail in the Commission's release announcing its approval of the rules, which is attached to this statement as Exhibit A.

[38] For cases involving public customers, arbitration panels at the SROs have historically been composed of a majority of "public" arbitrators and a minority of "industry" arbitrators. All arbitrators, both public and industry, are required to be neutral, and may have no affiliation or bias toward either party. Small claims are resolved by a single public arbitrator. The American Arbitration Association ("AAA") amended its securities arbitration rules in 1987 to provide for mixed public/industry panels, although it has published no guidelines for who may serve as a public arbitrator. AAA Securities Arbitration Rule 17.

In addition, by incorporating disclosure provisions of the American Bar Association/American Arbitration Association Code of Ethics for Arbitrators into the Uniform Code, the SROs have clarified for arbitrators the information they must disclose to the parties, and clarified for parties the kinds of information to which they are entitled when making decisions about whether to accept the arbitrators selected by the SRO arbitration department or to make a challenge against an arbitrator, and to ask for a replacement arbitrator.[39] In large measure, these actions will enable parties to make more informed choices about whether to exercise any challenges to arbitrators, as we requested in our letter, and should serve to increase investor confidence in the fairness of the arbitration process.

A second key focus of the Commission's initiative addressed by the new SRO rules concerned the need for enhanced access to discovery in arbitration.[40] The SROs have adopted a new rule that creates a formal mechanism through which parties may obtain arbitrator assistance in securing documents and other information prior to the arbitration hearing, and in setting a specific time frame for parties to request information and respond to information requests. Further, the new SRO discovery rules permit arbitrators to order depositions to preserve the testimony of ill or dying witnesses, or persons who are unable or unwilling to travel long distances for a hearing. Depositions also may be ordered to expedite large or complex cases and in other situations in which the arbitrators deem it appropriate.

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39. Also consistent with the Commission's recommendation, the SROs amended their rules to provide that expanded background information on arbitrators is to be provided to the parties at an earlier time in the process without parties having to request it. Parties retain the right to ask for additional information.

40. Under previous rules, parties had been expected to exchange documents informally and voluntarily. Parties also could request documents pursuant to subpoena, but subpoenaed documents do not have to be produced until the day of the hearing. The AAA has no procedure comparable to the new SRO rule establishing clear timetables for document exchanges, although its rules do provide for prehearing conferences that may resolve such disputes.

The Commission urged that the arbitration process be subject to public scrutiny through the publication of arbitration results. Prior to the Commission's initiative, the only information available to investors was the percentage of cases in which public customers were awarded some portion of the amount they claimed against their broker. This absence of information that would have disclosed the results of particular cases added to customer mistrust of SRO arbitration. In response, the SROs have adopted a new rule that expands both the content and public availability of arbitration awards. Arbitration awards now include the names of the parties, a summary of the issues in controversy, the damages and/or other relief requested and awarded, a statement of any other issues resolved, the date the claim was filed and the award rendered, the number and dates of hearing sessions, the location of the hearing(s), the names of the arbitrators and the signatures of the arbitrators concurring in the award. The awards currently are available through the SROs, and some newsletters and legal reporting services have begun to report the awards.[41]

At the Commission's urging, SICA also has considered whether there are better ways to handle the administration of class actions and other cases involving multiple parties with common claims. SICA concluded that judgments with respect to certifying class actions are best handled by the courts. Accordingly, it has announced a policy of declining to accept class actions unless they have been ordered into arbitration by a court. This policy, encouraged by Commission staff, rests on the understanding that courts could agree to handle class certification and notification issues, while ordering the merits of the cases to arbitration in accordance with the terms of the arbitration contracts.[42] SICA also recently amended the Uniform Code to clarify its rule governing the joinder of cases. The new rule would facilitate the ability of parties with common claims against broker-dealers and their employees to proceed jointly in those cases where claimants are not so numerous as to warrant class action procedures. The Commission will follow the experience in the areas of class actions and joinder closely to determine whether additional

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[41] Awards at the AAA are required to state the resolution of any statutory claims. AAA does not make any of its awards publicly available.

[42] *See e.g., Keating v. Superior Court*, 645 P.2d 1192 (Cal. 1982), *rev'd on other grounds sub nom., Southland Corp. v. Keating*, 464 U.S. 1, (1984).

Commission action is necessary to preserve the ability of investors to pursue claims jointly through arbitration.

The Commission also recommended certain changes to the administration of SRO arbitration programs that do not require rule changes. The SROs were asked to check the disciplinary history of prospective arbitrators; institute programs to educate and evaluate arbitrators; adopt staggered four-year terms for the public members of SICA; amend educational pamphlets for claimants; encourage the securities firms that utilize arbitration clauses to offer customers the option of arbitrating their disputes at the American Arbitration Association;[43] clarify for arbitrators their ability to refer to appropriate authorities cases in which they believe that the conduct alleged against a broker-dealer is particularly egregious; and explore the development of a flexible set of rules for large cases.

Much work related to these recommendations already has been accomplished. A first edition of an arbitrators' manual has been distributed to arbitrators, and the SROs have agreed to provide periodic additions and amendments. The manual addresses many issues confronting arbitrators, including disciplinary referrals and the ability to refer cases to the courts.[44] Further, both the NASD and the NYSE have expanded their training programs and the NYSE and AAA have collaborated to produce a new video training program for their arbitrators. The SROs' educational pamphlets for investors also have been updated to reflect the revised procedures brought about by the new rules. Arbitration departments now solicit detailed information concerning the disciplinary history of prospective arbitrators, and check the regulatory files for the records of current or past industry personnel. SICA has recently approved sample evaluation forms to be completed by parties, SRO personnel and arbitration department staff, which the SROs have begun to use. SICA has also adopted a plan to rotate public representation in the Conference. These efforts reflect a good start in implementing the administrative reforms recommended by the Commission.

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[43] The American Arbitration Association is a private, not-for-profit organization that administers arbitration proceedings and other forms of private dispute resolution processes. AAA modified its commercial arbitration rules in 1987 in order to accommodate securities arbitrations cases. References to AAA rules in the testimony refer to AAA's Securities Arbitration Rules. The Commission has no oversight authority over the AAA's rules or administration of its rules.

[44] The new manual states that certain complex claims may be appropriate for litigation in the courts. The manual suggests that it may be appropriate to refer parties to the courts in cases where all necessary parties have not agreed to arbitration, class actions and derivative actions, cases that involve substantial legal issues for which the establishment of legal precedent is important, and cases in which witnesses or documents essential to a fair and final decision are unavailable in the arbitral forum.

Notwithstanding the implementation of major improvements to the SRO arbitration process, more remains to be done. In particular, SICA and the SROs have not yet identified specific areas where alternative rules for large and complex cases would be appropriate. As more complex disputes come to arbitration, the need for appropriate procedures will heighten. The Commission staff has encouraged SICA to renew its efforts to develop flexible alternative rules for complex cases.[45] We also believe that the SROs must undertake to provide more advanced training for arbitrators. Arbitrators should be provided guidance both with respect to the administration of large and complex cases, and with respect to basic securities market operations.

Because of increasing demand for the use of arbitration facilities, the SROs must continue to maintain and enhance the quality of their arbitrator pools by looking to new sources for prospective arbitrators. We will be monitoring how SROs are using the new arbitrator evaluation forms, and whether this system permits them to identify more readily their most able arbitrators, and those who either require further training, or who should no longer serve on panels.

The SROs must continue to find ways of educating parties, public investors, and the media about how the arbitration process works. Updates to the arbitrator manual and materials discussing SRO policy should be disseminated on a timely basis, no later than the time when procedures or policies are changed. We believe that an open and continuing dialogue between the SROs and a variety of audiences would assist in correcting an incorrect perception that arbitration has an industry bias.

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[45] The Commission had asked SICA to explore the feasibility of alternative means of arbitrator selection that are used in other forums for large cases. Discussions in the Conference have not resulted in plans to offer parties options on arbitrator selection. However, SICA recently agreed, at the staff's renewed request, to study the issue.

The Commission is concerned that increasing costs in the securities industry as a whole, and particularly at the SROs, not constrain the nationwide availability of arbitration hearings at a reasonable cost to investors. We will monitor the SROs' programs closely to assure that fees to investors are not unduly high, and that convenient facilities remain available to investors. The Commission will remain watchful for particular arbitration procedures that, as a matter of structure, operate in a manner that is unfair to investors.

B. Arbitration Clauses

On July 8, 1988, the Commission sent to all SROs that administer arbitration programs a letter requesting that they examine issues surrounding their members' use of predispute arbitration clauses. The letter followed a study by the Commission staff of 65 broker-dealers that account for approximately 90% of all customer trading accounts in the United States. The study revealed that 96% of the margin accounts, 95% of the options accounts and 39% of the cash accounts at those firms were subject to predispute arbitration clauses.[46]

The industry-wide use of the predispute arbitration clauses, and in particular the reported trend toward the use of predispute clauses for cash accounts, was troubling. The Commission was concerned that opportunities for public customers to negotiate the exclusion of arbitration clauses from their account opening agreements appeared to be limited and often not meaningful. Further, it appeared that many customers were not provided with clear and informative disclosure of the meaning of the clauses.

In testimony before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce on July 12, 1988, then Chairman David Ruder stressed the Commission's expectation that the SROs would address the lack of clear and informative disclosure to investors opening brokerage accounts concerning the existence and meaning of predispute arbitration clauses. The testimony also noted the Commission's expectation that the SROs' response to the Commission's July 1988 letter would address the appropriate content of arbitration clauses, in order to prevent broker-dealers from limiting the substantive relief available to investors. Finally, the testimony stressed the need for the SROs to consider developing procedures that would permit investor access to the courts in appropriate cases — such as in highly complex matters.

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[46] A full summary of the staff's statistical findings on the use of arbitration clauses is attached to this statement as Exhibit B. A copy of this summary also was submitted for inclusion into the record for the hearings on arbitration reform in 1988 before the House Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce.

The SRO rules approved by the Commission in May 1989 and the new training and educational materials developed by the SROs and SICA address all of the issues raised in the Commission's July 1988 letter. One of those new rules requires broker-dealers that employ predispute arbitration clauses to place immediately before the clause highlighted introductory language informing customers that they are waiving their right to seek remedies in court, that arbitration is final, that discovery is generally more limited than in court proceedings, that the award is not required to contain factual findings or legal reasoning, and that the arbitration panel typically will include a minority of arbitrators associated with the securities industry.

The new arbitration clause rule also prohibits SRO members from having agreements with customers that limit or contradict the rules of any SRO, that limit the ability of a customer to file any claim in arbitration, or that limit the ability of the arbitrators to make any award. This provision makes clear that an agreement to arbitrate represents solely a choice of forum for the resolution of customer/broker-dealer disputes. The rule prohibits agreements that would curtail any substantive rights that a party may otherwise have had in a judicial forum. For example, if punitive damages or attorneys fees would be available under applicable law, then the agreement cannot limit parties' rights to request them, nor arbitrators' authority to award them. Similarly, the agreements may not be used to shorten applicable statutes of limitation, to restrict the situs of an arbitration hearing contrary to SRO rules, or to limit SRO forums otherwise available to parties.[47]

The new SRO rules do not require that broker-dealers offer customers account agreements without predispute arbitration agreements. In its release announcing the approval of the SROs' new arbitration rule, the Commission concluded that

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[47] *See* Securities and Exchange Commission Litigation Release No. 12198 (August 7, 1989).

> approval of [the] rule, which does not include provisions mandating customer choice with respect to the signing of arbitration clauses is consistent with the Act. . . . Investors currently have access to basic brokerage services without agreeing to pursue any future disputes through arbitration, rather than through the courts. This is so because a number of broker-dealers, including several large full service broker-dealers in the country, do not require the signing of account agreements for cash accounts. (footnote omitted) . . . The Commission, however, will carefully monitor the effectiveness of the SRO disclosure provisions as well as any increased usage of predispute arbitration agreements for cash account customers.

As indicated in the release, the Commission staff is monitoring industry use of arbitration provisions, and will recommend changes to the Commission should industry practice warrant them.

C. SRO Resources

The demands upon the SRO arbitration departments have grown significantly in the past five years. The number of cases filed with the SROs grew from 2,796 in 1985 to 6,101 in 1988, an increase of 118%. While we have not received completed figures yet for 1989, the data from the two largest forums, the National Association of Securities Dealers and the New York Stock Exchange, showed case levels, which, while slightly reduced from 1988, remain far higher than earlier years.[48]

The Commission staff believes that the SROs are making reasonable efforts to match the increase in demands for arbitration services with adequate resources. Cases at the NYSE averaged 8.2 months in 1988 and 9.4 months in 1989. At the NASD, cases averaged 12.1 months in 1988, and 11.5 months in 1989. Arbitration cases appear to be completed more quickly than court litigation. A study commissioned by the NYSE to compare the results of arbitrated and litigated cases at six large brokerage houses revealed that for the sample cases, the average time for the resolution of litigated cases was 30% greater than for cases that were arbitrated.[49]

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[48] The NASD received 3651 cases in 1989, down 8% from 1988. The NYSE received 1407 cases in 1989, down 13% from 1988.

As part of its arbitration reform initiative, the Commission recommended that SROs implement administrative changes to reduce delays in the pleading, scheduling and hearings stages of the cases. The SROs have taken a number of actions to expedite cases in response to the Commission's recommendations. One SRO initiative approved by the Commission in May 1989 transferred the responsibility for serving most pleadings from arbitration department staff to the parties to the proceeding. We are hopeful that this rule change will contribute to a further decrease in case turnaround times at the NASD, which, with roughly two thirds of all arbitration cases, has by far the largest case docket. The NASD has also been increasing its use of computers to administer its program, and its new computer system is now scheduled to be on line in April 1990.

Another new rule approved in May 1989 requires parties to serve on one another at least ten days prior to the first hearing copies of documents that they intend to present at the hearing and to identify witness they intend to present. Application of the rule does not extend to documents they intend to introduce or witnesses they intend to call for cross-examination or rebuttal. The rule should eliminate delays caused by surprise, and the need for parties to seek adjournments to consider new information. Arbitrators have the authority to exclude from the arbitration documents not exchanged or witnesses not identified in accordance with the rule.

In another effort to reduce delays in the administration of cases, SICA recently changed the Uniform Code by instituting a schedule of fees payable by parties that request adjournments after arbitrators have been appointed. The change is directed at a reported practice of parties' requesting adjournments

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49. The Commission's Office of Economic Analysis ("OEA") conducted an independent review of the data collected for the NYSE study by the accounting firm of Deloitte Haskins and Sells. OEA found that the data support the conclusion that arbitrated cases are resolved more quickly, and at lower legal cost to broker-dealers, and that the data comparing the amount recovered by investors in arbitration and litigation did not demonstrate statistically significant differences.

simply to delay cases.[50] The rule provides that arbitrators may direct the return of the fee, which should soften any potential harsh effect of the fee schedule on parties.[51]

We believe that the SROs are making serious efforts to administer their caseload efficiently. The changes to case administration outlined above should contribute to more timely processing of customer arbitrations, although further steps may be necessary.

Finally, SICA and the Securities Industry Association, among others, have called for a study of the feasibility and desirability of creating a unified forum for the resolution of disputes between customers and brokers and dealers. The Commission looks forward to receiving further information on the costs and benefits of this proposal as well as any other alternatives that are developed to improve the delivery of quality arbitration services at reasonable cost.

D. Overview of Arbitration Regulation

In overseeing changes in the arbitration process, it has not been the Commission's goal to transform arbitration into an equivalent of the court system. The Commission and staff constantly contend with the potentially conflicting objectives of achieving procedural rules that permit the vindication of statutory rights under the federal securities laws, while maintaining a forum for resolving disputes that provides the traditional characteristics and advantages of arbitration. Streamlined discovery procedures and expert triers of fact, for example, are characteristics of arbitration that, when administered by fair arbitrators, contribute to fair, efficient and final dispute resolution. Particularly for small investors, these efficiencies are important to the ability to achieve relief. Small investors do not have the means to sustain protracted and complex litigation in the courts against sophisticated brokerage firm counsel.

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[50] This rule has not yet been approved by the Commission. Once particular amendments to the Uniform Code are approved by SICA, individual SROs determine whether to adopt the provisions as part of their respective arbitration rules. Then, the individual SROs submit the rules for Commission approval. No SRO has yet submitted the proposal concerning adjournments, and the Commission has not considered whether it would be consistent with the public interest to approve the rule.

[51] One focus of the staff's inspection program is to examine whether broker-dealers and investors are treated equitably in the arbitration proceedings. In this connection, the staff reviewed the treatment of broker-dealers' and investors' extension requests and requests for adjournments, and uncovered no disparate treatment of the parties.

Our efforts to reform the arbitration process have been directed at improving the procedural fairness of SRO arbitration and at amending procedures that gave rise to the appearance of bias or the public's perception of unfairness. The Commission's efforts were directed also at the creation of effective disclosure so that investors understand what rights they are waiving when they sign predispute arbitration clauses. We are anxious to continue working with the Subcommittee on ways to ensure continued investor confidence in the securities markets, and in the arbitration forums available to resolve grievances with broker-dealers.

Commission initiatives during the last two years have resulted in significant improvement in the rules governing the resolution of investor grievances. Moreover, the SROs have demonstrated through their commitment of significant additional resources that they are willing to provide fair and efficient forums at a reasonable cost to investors. Individual SROs, operating within a common set of rules, have been able to draw on the expertise of their markets to develop pools of qualified arbitrators. SROs also have emphasized their authority to ensure that members, and associated persons of members, obey orders of arbitrators and pay investors awards rendered by the arbitrators. The Commission will continue its close oversight of the procedures for resolution of disputes, and will seek to implement any further changes that become appropriate as we gain experience under the new rules.

VI. CONCLUSION

Those who lie to the public to sell penny stocks and manipulate the prices of those securities are robbing small investors of their life savings, retirement funds, or money set aside for educating children. Beyond these individual economic tragedies, they are destroying the trust that lies at the foundation of the nation's securities markets. Simple arithmetic shows that every dollar lost to a fraudulent penny stock scheme is a dollar that might otherwise have gone to an honest business and resulted in job creation, research, development and discovery of new and beneficial technology or medical breakthroughs, and other benefits to our society that have characterized the American capital-formation process, particularly as it relates to emerging small businesses.

In its war against penny stock fraud, the Commission has made significant progress in increasing enforcement actions and criminal referrals, enacting regulatory initiatives, providing investor education, and fostering cooperation with other law enforcement authorities. Securities and criminal authorities are galvanized in a unified front to attack penny stock fraud. We have successfully undercut the rapid expansion of broker-dealers engaged in penny stock fraud, secured the prosecution of many key promoters and principals running national and international fraud networks and increased investor protection in the foreseeable future through new regulatory initiatives.

Commission initiatives have produced significant improvement in the rules governing the resolution of investor grievances. The Commission is committed to continue its efforts with the SROs to assure that fair, efficient and affordable arbitration facilities remain available for investors who have been the victims of penny stock fraud, or who have other disputes with their brokers.

Despite our efforts, penny stock fraud has not disappeared. Much remains to be done from an enforcement, regulatory and legislative standpoint if we are to be successful in eradicating this blight. The Commission is committed to continuing to devote substantial resources to protect the investing public from penny stock fraud.

EXHIBIT A

SECURITIES EXCHANGE ACT RELEASE NO. 26805
APPROVING THE NEW SRO ARBITRATION RULES

[Release No. 34-26804; File No. SR-GSCC-89-3] 54 FR 21332 (5/17/89)

Self-Regulatory Organizations; Filing and Immediate Effectiveness of Proposed Rule Change by Government Securities Clearing Corporation ("GSCC") Relating to Its Fee Structure

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934, 15 U.S.C. 78s(b)(1), notice is hereby given that on April 14, 1989 GSCC filed with the Securities and Exchange Commission the proposed rule change as described in Items I, II, and III below, which Items have been prepared by GSCC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The proposed rule change would modify GSCC's fee schedule to establish a minimum monthly fee of $500.00 that each participant must remit to GSCC.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, GSCC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. GSCC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) The purpose of the proposed rule change is to establish a minimum monthly fee, for each member of the Comparison System, for use of GSCC's trade comparison services. This minimum fee will ensure that GSCC receives sufficient revenues on a regular basis to be able to meet the fixed expenses associated with providing trade comparison services.

(b) The proposed rule change provides for a minimal minimum monthly fee that is based on GSCC's fixed expenses and is equitably allocated; it is, therefore, consistent with the requirements of the Securities Exchange Act of 1934, as amended (the "Act"), and the rules and regulations thereunder applicable to a self-regulatory organization.

B. Self-Regulatory Organization's Statement on Burden on Competition

GSCC does not believe that the proposed rule will have an impact on, or impose a burden on, competition.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Comments on the proposed rule change have not been solicited or received. Members will be notified of the rule filing, and comments will be solicited, by an Important Notice. GSCC will notify the Securities and Exchange Commission of any written comments received by GSCC.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The foregoing rule change has become effective, pursuant to Section 19(b)(3)(A) of the Securities Exchange Act of 1934 and subparagraph (e) of Securities Exchange Act Rule 19b-4. At any time within 60 days of the filing of such proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Securities Exchange Act of 1934.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street NW., Washington, DC 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street NW., Washington, DC 20549. Copies of such filing will also be available for inspection and copying at the principal office of the above-mentioned self-regulatory organization. All submissions should refer to SR-GSCC-89-3 and should be submitted by June 7, 1989.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.

Jonathan G. Katz,
Secretary.

May 9, 1989.

[FR Doc. 89-11800 Filed 5-16-89; 8:45 am]

BILLING CODE 8010-01-M

[Release No. 34-26805; File Nos. SR-NYSE-88-29; SR-NYSE-89-8; SR-NASD-88-29; SR-NASD-88-51; SR-NASD-89-19; SR-AMEX-88-29] 54 FR 21144 (5/16/89)

Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc., National Association of Securities Dealers, Inc., and the American Stock Exchange, Inc. Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses

I. Introduction and Background

The New York Stock Exchange, Inc. ("NYSE"), the National Association of Securities Dealers, Inc. ("NASD") and the American Stock Exchange, Inc. ("AMEX") have each submitted to the Securities and Exchange Commission ("Commission" or "SEC") [1] proposed rule changes pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act") [2] and Rule 19b-4 thereunder [3] to amend their current rules for administering arbitration proceedings.[4] The proposed amendments address many issues regarding the fairness and efficiency of the arbitration process administered by the SROS and also would institute new requirements applicable to the use by SRO members of predispute arbitration clauses in agreements with customers.

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[1] SR-NYSE-88-29 was submitted on October 14, 1988 and amended on January 6, 18 and 19, 1989 and April 28, 1989. SR-NYSE-89-8 was submitted on March 28, 1989 and amended on October 11, 1988 and January 18, 1989. SR-NASD-88-29 was submitted on July 1, 1988 and amended on September 19, 1988, October 7, 1988, April 18 and 19, 1989 and May 5, 1989. SR-NASD-88-51 was submitted on November 7, 1988 and amended on December 23, 1988, January 30, 1989 and April 18, 1989. SR-NASD-89-19 was submitted on March 27, 1989 and amended on April 17, 1989. SR-AMEX-88-29 was submitted on November 18, 1988 and amended on April 28, 1989 and May 3, 1989.

In addition, the Municipal Securities Rulemaking Board ("MSRB"), the Pacific Stock Exchange ("PSE") and the Midwest Stock Exchange ("MSE") have also submitted proposed changes to their arbitration rules. The MSRB submitted its filing, SR-MSRB-88-4 on November 22, 1988, and submitted amendments on March 13, 1989. The PSE submitted its filings, SR-PSE-88-7 on October 24, 1988 and SR-PSE-19 on November 8, 1988. The MSE submitted its filing on December 23, 1988. These filings are currently being reviewed and, accordingly, are not included in this approval order.

[2] 15 U.S.C. 78s(b)(1).

[3] 17 CFR 240.19b-4 (1987).

Notice of the proposed rule changes together with the terms of substance of the proposals was given by the issuance of Securities Exchange Act releases and by publication in the **Federal Register**.[5] Eight comment letters were received from six commenters regarding the proposals. All of the commenters expressed general support for the revisions to the SROs' rules relating to arbitration, but had specific comments on certain provisions in the proposals. The Commission has reviewed carefully the filings submitted by the SROs, as well as the comments received, and has determined that the proposed rule changes are consistent with the Act, including those requirements set forth in section 6(b) and 15A(b) of the Act.

II. Background

The SROs have worked together over the past twelve years to develop uniform arbitration rules through the auspices of the Securities Industry Conference on Arbitration ("SICA"). SICA was formed by the securities industry in 1977 at the Commission's invitation to review then existing arbitration procedures as an alternative to the implementation of the Commission's own proposals to establish a system for the resolution of disputes between broker-dealers and their customers.[6] SICA is comprised of a representative from each SRO that administers an arbitration program,[7] a representative of the securities industry, and four representatives of the public. In the years between the initial development of the Uniform Code of Arbitration ("Uniform Code") and September 1987, SICA met periodically to discuss issues that arose in the administration of the code, and to develop any necessary amendments.

On September 10, 1987, after a review of securities industry-sponsored arbitration, the Commission sent to SICA a letter that set out its views regarding the need for changes to the Uniform Code.[8] The Commission also sent letters to the SROs on July 8, 1988 requesting that the SROs review the issues raised by the current use of mandatory predispute arbitration agreements by their member firms.[9] Since September 1987, SICA and its subcommittees have met regularly to develop proposals in response to the Commission's letters.

The SROs have filed nearly identical rule proposals. For convenience, the discussion in the text of the proposals sometimes refers only to NYSE rule numbers. The corresponding rules of the NASD and AMEX are referenced in the footnotes, which also identify differences among the SROs' rules.

The majority of the proposals to amend the SROs' rules were based on changes in the Uniform Code made by SICA largely in response to the September 1987 and July 1988 Commission letters.[10] The other proposals included in this order were developed to meet concerns that have arisen through the administration of the arbitration programs.

III. Description of the Proposals, Summary of Comments and Analysis

A. Service of Pleadings

The SROs have proposed to modify the procedures for service of pleadings. Currently, the arbitration departments of the SROs serve all pleadings on the parties. As cases have increased, using the arbitration department as an intermediary for the service of pleadings has added unnecessarily to delays in processing cases and to the cost of operating the arbitration system. The SROs propose to serve only the initial pleading in a case, the "claim," and to require that parties serve all subsequent pleadings directly upon one another. This approach is intended to save administrative time and costs while continuing to ensure that respondents receive adequate notice of the institution of arbitration proceedings.

Under the proposal, parties also will be required to supply the department of arbitration with sufficient copies of the pleadings for the arbitration department staff and each of the arbitrators. The proposal specifies that service by first-class postage prepaid or by overnight mail service is considered to be made on the date of mailing and service by other means is considered to be made on the date of delivery.

This proposed rule change would apply both to arbitration proceedings conducted pursuant to the simplified procedures for small claims under NYSE Rule 601 and regular cases initiated pursuant to NYSE Rule 612.[11] No commenters specifically addressed this proposal. The Commission believes that this proposed rule change should improve the efficiency and speed of arbitration proceedings administered by the SROs.

B. Classification of Arbitrators

The arbitration panels at the SROs for cases involving public customers have historically been composed of a majority of "public arbitrators" and a minority of "industry arbitrators". All arbitrators, both public and industry, are required to be neutral, and may have no affiliation or bias towards either party.[12] There have not been, however, clear requirements or specifications for who may serve as a public arbitrator. The SROs' proposals would specify who may not serve as a public arbitrator and who may serve as an industry arbitrator.

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[4] Collectively these organizations are referred to below in the text as the self-regulatory organizations ("SROs").

[5] Noticed of SR-NYSE-88-29 was given in Securities Exchange Act Release Number 26474, (January 19, 1989) and in 54 FR 3883, (January 26, 1989). Notice of SR-NYSE-89-8 was given in Securities Exchange Act Release No. 26515, (February 2, 1989) and in 54 FR 6224, (February 8, 1989). Notice of SR-NASD-88-29 was given in Securities Exchange Act No. 26242, (November 2, 1988), in 53 FR 45640, (November 10, 1988). Notice of SR-NASD-88-51 was given in Securities Exchange Act Release No. 26584, (March 1, 1989) and in 54 FR 9866, (March 8, 1989). Notice of SR-NASD-89-19 was given in Securities Exchange Act Release Number 26718, (April 12, 1989), and in 54 FR 15860 (April 19, 1989). Notice of SR-AMEX-88-29 was given in Securities Exchange Act Release No. 26475, (January 19, 1989) and in 54 3878, (January 26, 1989).

[6] The resulting Uniform Code of Arbitration is also used for the resolution of intra-industry disputes, (*e.g.*, disputes between members of an SRO or between a member of an SRO and an associated person of a member, such as a registered representative.) Unless otherwise limited by the terms of the rules, the amendments included in this filing also pertain to intra-industry disputes.

[7] The SROs that administer an arbitration program are the NYSE, NASD, AMEX, MSRB, PSE, MSE, Boston Stock Exchange, Chicago Board Options Exchange, Cincinnati Stock Exchange and Philadelphia Stock Exchange.

[8] *See* letter frm Richard G. Ketchum, Director, Division of Market Regulation, SEC, to James E. Buck, Senior Vice President, NYSE, dated September 10, 1987 ("September 10, 1987 letter"). This letter was also addressed separately to each of the other members of SICA.

[9] *See* letter from David S. Ruder, Chairman, SEC, to John J. Phelan, Jr., Chairman, NYSE dated July 8, 1988 ("July 8, 1988 letter"). This letter was also addressed to the senior executive officers of all other SROs that administer arbitration facilities.

[10] The SRO rules developed in response to the Commission's letters are NYSE Rules 607, 608, 610, 618, 623, 627, 629(b) and 637; AMEX Rules 602, 603, 607, 614, 618, 630(b) and 427; and NASD Sections 18, 21, 23, 32, 37, 41 and 43(b) of the NASD Code of Arbitration Procedure and Section 21 of Article III of the NASD Rules of Fair Practice.

[11] AMEX Rules 608 and 621, and NASD Sections 13 and 25. In addition, the proposed rule change to the NASD's Section 25 provides that where both an NASD member firm and a person associated with the member firm are named parties to an arbitration proceeding, service on the associated person may be made either on the associated person, or on the member firm, which would then have the obligation to perfect service on the associated person. Proposed Section 25 also provides that if the firm does not undertake to represent the associated person, the member firm must serve the associated person, advise all parties and the director of arbitration that the firm is not representing the associated person, and must provide the associated person's current address. The NYSE and AMEX did not propose such a requirement.

In its September 10, 1987 letter, the Commission endorsed the continued use of mixed public/industry panels. The Commission also stated, however, that "[t]he absence of clear guidelines for qualifying public arbitrators * * * and the inclusion in the pool of public arbitrators of persons with clear affiliations with the securities industry is a source of great concern." The Commission recommended that "arbitration panels include persons who are not so connected with the industry that it may hinder their ability to make independent judgments with respect to specific industry practices." The letter set out specific examples of types of persons who the Commission preliminarily believed should not serve as public arbitrators. In response to the SEC's request, SICA revised its definition of public and industry arbitrators. The proposals address the potential for real or apparent bias on the part of public arbitrators who may have some professional or personal association with the securities industry.

The Uniform Code defines as an industry arbitrator one who is associated with a member of an SRO, broker, dealer, government securities broker, government securities dealer, municipal securities dealer, or registered investment adviser. The SICA rule permits an individual who had been associated with one of these to become a public arbitrator after three years, if the individual has gone on to other work and is not retired from the securities industry. All industry retirees will no longer be permitted to serve as public arbitrators, but may continue to serve as industry arbitrators.

The rule also deals with the appropriate role in the arbitration system of professionals such as attorneys or accountants who provide services to securities industry clients. The rule would classify as industry arbitrators, rather than public arbitrators, attorneys, accountants and other professionals who devoted twenty percent or more of their professional work effort to securities industry clients within the last two years. In addition, the rule excludes from service as a public or industry arbitrator persons who are spouses or other members of the household of a person associated with a registered broker-dealer, municipal securities dealer, government securities dealer or investment adviser.

NYSE Rule 607 defines industry and public arbitrators differently in two respects from the rule developed by SICA and adopted by the other SROs. The NYSE has extended from three years to five years the time period during which one who had been employed in the securities industry may not serve as a public arbitrator. In addition, the NYSE has proposed to exclude anyone from its public arbitrator rolls who had spent a substantial part of his or her business career in the securities industry, notwithstanding the passage of five years. Accordingly, under the NYSE proposal, an individual who had worked in the securities industry for a substantial period of time and then left the profession for some other work would not, after five years, be assigned to its public arbitrator roster.[13]

The AMEX rule for the classification of arbitrators is Rule 602, and the NASD rule is Section 19. The AMEX and NASD rules do not include the two changes from the Uniform Code that have been proposed by the NYSE. Further, while the NYSE and AMEX have included persons associated with investment advisers within their industry arbitrator pools consistent with the Uniform Code, the NASD has concluded that investment advisers not associated with broker-dealers are more akin to investors and should be placed in the public arbitrator pool.

The SROs also proposed disclosure provisions designed to assist parties in assuring that the panel assigned to each case is appropriately balanced. Specifically, under the proposed SRO rules, the employment histories of the arbitrators for the past ten years as well as the information provided by arbitrators pursuant to a separate disclosure rule[14] will be disclosed.[15]

Four commenters, Public Citizen Litigation Group ("Public Citizen"), Plaintiff Employment Lawyers Association ("PELA"), Shearson Lehman Hutton ("Shearson") and the Securities Industry Association ("SIA") submitted comments regarding the selection of arbitrators.[16] Public Citizen stated that these proposals do not go far enough to address concerns of arbitrator bias.[17] It observed that the qualifications for public arbitrators are not strict enough. It believes that a three year period between securities industry employment and serving as a public arbitrator is too short, particularly in the case of one who has worked in the securities industry for a long time. In contrast, the SIA, which endorsed the proposals with respect to public and industry arbitrators, commented that it believed that the three year period established by SICA for permitting former securities industry personnel to serve as public arbitrators was preferable to the NYSE's five year rule. The SIA stated that it thought that the five year rule would make it too difficult to find public arbitrators, and commented that the Commission should suggest that the NYSE conform its rule to SICA's Uniform Code.

Also, Public Citizen objected to persons whose partners represent the securities industry being able to serve as public arbitrators. Public Citizen argued this to be inappropriate because the economic ties between partners give rise to an appearance of bias that should exclude such persons from the public arbitrator pool. Public Citizen suggested that at a minimum parties be allowed challenges for cause against such persons. Finally, Public Citizen commented that the provision allowing professionals such as lawyers and accountants who have received some income from securities industry clients (not exceeding 20% during over a two year period) to serve as public arbitrators is overly permissive. It commented that 20% could constitute an attorney's "single greatest and most consistent source of income." Public Citizen suggested a flat rule prohibiting public arbitrators from receiving any income from the securities industry.[18] Shearson supported the new definitions of public and industry arbitrators.

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[12] This is different from tripartite arbitration where each party designates an arbitrator and the designated arbitrators then agree upon a third arbitrator. *Cf.*, Elkouri, Frank et al., *How Arbitration Works*, 4th ed. (1985), BNA, at page 138; and *Domke Comm. Arb.* § 27.01 (Rev. ed., Wilner) 1984–1988 Callahan & Co.

[13] The NYSE has also included in its filing guidelines for the classification of arbitrators to complement its classification rule. In the guidelines, the NYSE states that while it will continue to classify as public arbitrators lawyers and other professionals whose partners represent the securities industry, it will recognize challenges for cause against them.

[14] The disclosure rule is a proposed rule change discussed in Section C of this order. The rule would require arbitrators to make extensive disclosures to the parties.

[15] NYSE Rule 608, AMEX Rule 610 and NASD Section 23.

[16] *See* letters from Eric R. Glitzenstein, Esq. and Alan B. Morrison, Esq., Public Citizen, to Richard G. Ketchum, Director, Division of Market Regulation, SEC, and to Catherine McGuire, Special Assistant to the Director, Division of Market Regulation, SEC, dated July 15, 1988 and February 16, 1989, respectively; letter from Cliff Palefsky, Esq., PELA, to Robert Love, Special Counsel, SEC, dated December 28, 1988; letter from Robert C. Dinerstein, Executive Vice President and General Counsel, Shearson, to Jonathan G. Katz, Secretary, SEC, dated February 15, 1989; and letters from William Fitzpatrick, Senior Vice President and General Counsel, SIA, to Jonathan G. Katz, dated February 15 and 16, 1989.

[17] PELA commented that while the new rules were a significant improvement, the arbitrator pool needed to be broadened. While its comments did not address specifically the proposals before the Commission, PELA expressed its view that panels should include plaintiffs' lawyers as well as the defense lawyers that it believes now are on the panels, and that there are insufficient women and minorities on the panels.

The changes proposed regarding the classification of arbitrators are very significant to the continued success of SRO arbitration. These proposals are designed to promote impartial and knowledgeable decisions in the arbitration of disputes between investors and broker-dealers. The reclassification of securities industry retirees to the industry arbitrator pool and the codification of past SRO practice by establishing a three year period before a former securities industry employee may serve as a public arbitrator should relieve doubts that investors have had regarding the impartiality of the public arbitrator pool. Similarly, the judgment to exclude from the public arbitrator pool lawyers, accountants and other professionals who regularly service the securities industry makes clearer the distinctions between the two arbitrator pools.[19]

The Commission believes that these proposals reflect a reasonable judgment in striking a necessary balance in obtaining impartial and qualified arbitrators, and take appropriate account of the need to avoid arbitrarily limiting the pool of knowledgeable public arbitrators. The three year time period proposed by the NASD and the AMEX, and five year period of time that has been proposed by the NYSE, before one who had been associated with the securities industry may serve as a public arbitrator, are both consistent with the Act. Three years should be a sufficient period of time, in the Commission's view, to develop the prospective arbitrator's independence from identification with the industry. Five years also achieves that goal and should not be overly burdensome to the administration of arbitration programs.

The disclosure of arbitrators' employment history and other information also furthers the goal of providing disinterested arbitrators for the panels. The disclosures will give parties a full understanding of their arbitrators' backgrounds, as well as the opportunity to use the disclosure information in connection with the exercise of their peremptory and, under the NYSE guidelines, cause challenges of arbitrators. For example, the requirement under the proposed rules[20] that a prospective arbitrator disclose whether his partners regularly represent the securities industry, coupled with the ability to challenge a prospective arbitrator, should be sufficient to address the concerns regarding the independence of arbitrators raised by Public Citizen.

C. Arbitrator Disclosure and Background Information to be Supplied to the Parties

The SROs have also proposed changes to their rules dealing with disclosures to be made by arbitrators, and with the provision of arbitrator disclosures to the parties. NYSE Rule 610(a) establishes the specific disclosure obligations of arbitrators by incorporating the disclosure provisions of the American Bar Association/American Arbitration Association Code of Ethics for Arbitrators in Commercial Disputes ("ABA/AAA Code").[21] The rule requires that arbitrators disclose any existing or past financial, business, professional, family or social relationships that are likely to affect impartiality or might reasonably create an appearance of partiality or bias. These disclosures extend to any relationships the arbitrators may have with any party, or its counsel, or with any individual whom they have been advised will be a witness. Under the provision, arbitrators are also to disclose any such relationship involving members of their families or their current employers, partners or business associates.

Rule 610(b) admonishes prospective arbitrators to make a reasonable effort to inform themselves of any interests or relationships described in paragraph (a) Rule 610(c) advises arbitrators that the duty to disclose under paragraph (a) of the rule is an ongoing duty, and that any person who serves as an arbitrator must disclose at any stage of the arbitration proceeding any such interests, relationships, or circumstances that arise, or that are recalled or discovered Also, under Rule 610(d), the NYSE has clarified that prior to the first session, the director of arbitration may remove an arbitrator based on information disclosed pursuant to the rule. Parties are to be informed of any information disclosed pursuant to the rule if the arbitrator has not been removed.[22]

As discussed above, NYSE Rule 608[23] provides that parties will be informed of the names and business affiliations of the arbitrators for the past ten years, as well as any information disclosed pursuant to the disclosure rule at least eight days prior to the date fixed for the initial hearing session. Under the rule, parties may also make further inquiry through the department of arbitration concerning the arbitrators' background.

Under the current rules, parties have been provided only with the names and current business affiliations of the arbitrators proposed for their cases. Parties have had to request specifically any other information from the arbitration departments, within very short time frames. Although arbitrators were provided with the ABA/AAA Code, there were no clear guidelines to the arbitrators on the applicability of the code.

In the Commission's September 1987 letter, the Commission recommended that SICA make the two changes proposed in these filings to the Uniform Code's arbitrator disclosure provisions. The Commission stated that incorporating the specific scope of disclosures for arbitrators contained in the ABA/AAA Code into the Uniform Code's disclosure rule "would provide the necessary guidance to arbitrators about the types of relationships that may create conflicts of interest."

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[18] Public Citizen also expressed strong reservations concerning the use of industry arbitrators. In particular, Public Citizen noted that industry arbitrators may be called upon in a particular case to interpret anti-fraud provisions which are also applicable to their business conduct. Public Citizen's letter also stated that public arbitrators are both neutral and expert, and that therefore further industry expertise is unnecessary. However, securities industry sponsored arbitration traditionally relies upon the expertise of securities industry arbitrators, who have daily experience with the workings of the industry that persons unaffiliated with the industry do not. Industry arbitrators are required to be neutral, and as discussed in Section C of this order, must disclose any possible conflict they may have with industry parties. The Commission cannot conclude at the present time that the use of industry arbitrators is inappropriate or inconsistent with the Act. The Commission will, however, carefully monitor the operation of these proposed rule changes and will consider modifications if future developments warrant.

[19] There are differences of judgement among the SROs' proposals with respect to whether investment advisers ought to serve as industry or public arbitrators. The SICA draft, proposed by the NYSE and AMEX, excludes investment advisers from the public arbitrator pool in the hopes of addressing any possible perceptions of bias that may arise. The NASD has concluded that because investment advisers owe their duty to investors rather than the industry, they are properly classified as public arbitrators. It is not inconsistent with the Act to permit this divergence in approach among the SROs.

[20] NYSE Rule 610(a)(2) AMEX Rule 603(a)(2) and NASD Section 23(a)(2).

[21] AMEX Rule 603 and NASD Section 23 also incorporate the disclosure provisions of the ABA/AAA Code.

[22] Once the arbitration panel is sworn, it controls all of the procedural aspects of the hearing. Accordingly, under the Uniform Code, the director of arbitration may not remove an arbitrator after the hearings have begun. An arbitrator should be alert to the guidelines set out in the ABA/AAA Code and the applicable law with respect to arbitrator bias and remove himself from the panel when conflicts arise after hearings have begun. *See* Canon II. B. (2) of the ABA/AAA Code.

[23] AMEX Rule 602 and NASD Section 21.

The Commission also recommended that the Uniform Code be amended to provide to the parties all of the information disclosed by arbitrators pursuant to the disclosure provision at the time when the parties are first given the arbitrators' names. The Commission stated that "[f]ull disclosure of arbitrators' backgrounds to parties at the earliest possible stage in the process should avoid unnecessary postponements of hearings and promote knowledgeable use of challenges."

Investor confidence in the selection of arbitrators should be enhanced by these new disclosure rules. These provisions should guide arbitrators in their efforts to make appropriate disclosures, and will permit disclosures to be forwarded to the parties earlier to allow time for them to make decisions with respect to challenges.

D. Appointment of Replacement Arbitrators on a Panel

The SROs have also proposed two changes with respect to their ability to appoint a replacement arbitrator on a panel when a vacancy occurs. The first of these changes concerns the ability of the director of arbitration to replace an arbitrator who becomes unavailable to serve less than eight days prior to the first hearing session. Under the existing rules, a party may refuse to go forward on the date scheduled for the hearing if he was not given the eight days' notice of the replacement arbitrator's name and background required under existing rules. Because of the hardships that the SROs believe might occur if a long-scheduled arbitration hearing were delayed due to the inability of an arbitrator to serve as arranged, SICA developed a rule that permits the director of arbitration to replace an arbitrator within eight days of a scheduled hearing.[84]

Under the proposed amendment, if after appointment and prior to the first hearing session an arbitrator resigns, dies, withdraws, is disqualified or otherwise unable to perform as an arbitrator, the director of arbitration may appoint a replacement arbitrator. The rule permits the appointment of replacement arbitrators closer than eight days to the hearing. The rule also explicitly provides that parties are entitled to receive the same disclosure regarding the background of the replacement arbitrator as they received for the initial arbitrator(s), and have the same right to request more information, and to challenge the arbitrator as provided in the rules, although within a shorter time frame.

The second change with respect to the ability to appoint replacement arbitrators occurs in situations where an arbitrator resigns, dies, withdraws, is disqualified or otherwise unable to perform as an arbitrator after the commencement of the first hearing session. Under the existing rules, if a vacancy occurs after the hearings have begun, both parties must consent either to the appointment of a replacement arbitrator to hear the rest of the case, or to continuing with the remaining arbitrator(s). Otherwise, if that consent cannot be obtained, the case must be reheard from the beginning with a full panel.

The proposed amendment[85] permits the remaining arbitrators to continue with the hearing and determination of the controversy. However, under the proposal, if a party objects, a replacement arbitrator would be appointed by the director of arbitration under the same procedures as for the replacement of an arbitrator prior to the first hearing. The rule is designed to permit parties in particular cases to make the decision that makes the most sense for their case. For example, in cases where only peripheral issues have been dealt with and relatively little progress has been made, it may make sense for parties to request a replacement arbitrator. Conversely, where the hearings have progressed significantly, or are in fact substantially completed, it would make less sense for parties to request a replacement arbitrator, who then would have to learn all that had occurred in his absence.

In the event that parties do request a replacement arbitrator, it is clear that the arbitrators have the authority to require the rehearing of part or all of the case, or to withdraw from the case, effectively requiring the appointment of another panel, as is appropriate in their judgment. With this rule change, however, a party may no longer delay the resolution of the dispute by insisting on a rehearing whenever an arbitrator unexpectedly is unable to continue in his hearing of a case. These changes should promote increased efficiency in the administration of SRO arbitrations while at the same time preserving important safeguards that provide full disclosure of arbitrator backgrounds to the parties and permit parties to request more data and exercise challenges.

E. Availability of Small Claims Procedures and the Number of Arbitrators Required to Hear a Claim

The NYSE and NASD also proposed to increase to $10,000 from $5,000 the monetary claim limit for cases to be heard under the simplified procedures developed in the Uniform Code. Under these procedures, a single arbitrator decides a case based upon the papers submitted by the parties. No oral hearing is held unless requested by the investor, or ordered by the arbitrator. This change is designed to decrease the costs of arbitration.

The proposal also would change the number of arbitrators used for large cases from five to three.[86] The NYSE stated in a letter to the Commission's staff that this proposal is the result of the Exchange's difficulty in scheduling arbitrations with five arbitrators.[87]

The NASD and AMEX proposed a technical amendment, in NASD Section 13 and AMEX Rule 621, regarding the single arbitrators used in cases administered under the simplified procedures. The amendment codifies the existing practice of appointing a public arbitrator as the single arbitrator in the case. The NYSE has confirmed that it administers its existing rule to require the appointment of a public arbitrator. The NYSE staff has indicated that it will recommend that the NYSE clarify this point through amendments to its rules this year.

The NASD has also submitted a proposal, that has not been adopted by SICA, AMEX or the NYSE, that would permit the NASD to appoint a single arbitrator for cases administered under its regular procedures where the amount in controversy is $30,000 or less. Under proposed NASD Section 9(e), a party may, however, request in its initial filing that the NASD appoint a panel of three arbitrators. The NASD stated that its proposal was designed to reduce costs and delays in the administration of cases, while preserving the opportunity for parties to have their cases heard before a full three member panel. The Commission believes that these changes also promote efficiency in the administration of the process without reducing procedural protections for the parties.

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[84] NYSE Rule 608, AMEX Rule 602 and NASD Section 21.

[85] NYSE Rule 611, AMEX Rule 602 and NASD Section 24. The amendments to NASD Sections 21 and 24 relating to the replacement of arbitrators were approved by the Commission on September 19, 1988 in Securities Exchange Act Release No. 26093 and published in 53 FR 37381 (September 26, 1988).

[86] These changes were submitted earlier to the Commission by the AMEX, and were approved on November 28, 1988 in Securities Exchange Act Release No. 26315, and published in 53 FR 48606 (December 5, 1988).

The AMEX also proposes to amend its Rule 608(e) to clarify the fact that charges under the arbitration rules imposed for requesting adjournments do not apply to cases administered under the simplified procedures. This change conforms the AMEX rule to the Uniform Code and NYSE Rule 617(b) and NASD Section 30(b).

[87] *See* letter from James E. Buck, Senior Vice President and Secretary, NYSE, to Sharon Lawson, Esq., Branch Chief, Division of Market Regulation, SEC, dated January 16, 1988.

F. Discovery

The Commission requested in the September 1987 letter that SICA adopt significant changes to the Uniform Code's discovery provisions. The Commission's letter pointed to the "need for the SROs to expand existing procedures in order to provide both for the resolution of discovery disputes by [an arbitrator] prior to the hearing and for prehearing conferences and preliminary hearings for cases that are sufficiently complex to warrant such procedures." The letter also called for the Uniform Code to provide parties the ability to seek the deposition of witnesses in appropriate cases.

Under the existing rules, parties have been enacted to exchange documents informally and voluntarily. Nevertheless, the Commission's letter points out, parties sometimes "refuse to turn over documents that are, in their view, privileged or irrelevant. Customer complaints and other documents evidencing supervision or lack of supervision of a registered representative, which are in the sole possession of the industry party and are often relevant to a complainant's case, should be turned over in a timely fashion." Parties may also request documents pursuant to subpoena under the existing rules, but these do not have to be produced until the day of the hearing.

The Commission's letter stated that it did not believe that existing rules provided sufficient time for a party to prepare for a hearing. The letter also pointed out that the risks to parties resisting production were inadequate to promote compliance with the rules. "The practical problem under the Uniform Code [has been] that the requestor does not know whether, on the day of the hearing, he is going to argue over discovery matters only or whether the arbitrators will proceed to resolve the case on the merits." The discovery rule proposed in these filings meets the concerns raised in our September 1987 letter.

The discovery rule developed by SICA expands party access to prehearing discovery and provides specific time frames for parties to request information from parties and for responding to such an information request. The rule also establishes a mechanism for prehearing conferences and for arbitrator involvement in prehearing matters where needed. The SROs also have explicitly recognized the appropriateness of depositions in particular circumstances. Under the proposed rule changes, arbitrators may order depositions when appropriate. More specifically, the rule states that an arbitrator in a prehearing conference may issue any "ruling which will expedite the arbitration proceeding or is necessary to permit any party to develop fully its case." [28]

Proposed NYSE Rule 619(a) [29] continues the policy established under existing rules for parties to cooperate to the fullest extent possible in the voluntary exchange of documents and information. In the event that voluntary exchanges are not sufficient, the rule establishes a clear framework for document production and information requests.

Proposed NYSE Rule 619(b) provides that a party may serve a written request for information or documents twenty days after service of the claim or upon the filing of the answer, whichever is earlier. All parties are to receive copies of the request, and parties are required to endeavor to work out disputes regarding the request between themselves before an objection to the request is filed. Unless the requesting party allows more time, information requests must either be satisfied or objected to within thirty calendar days from the date of service. The party who made an information request has ten days from receipt of the objection to respond to the objection.

Under the proposal, a party whose information request has not been satisfied may request in writing that the director of arbitration refer the matter to a prehearing conference. Parties may also find that there are other matters in addition to unresolved information requests that require the assistance of a prehearing conference. NYSE Rule 619(d) provides that the director of arbitration may appoint someone to preside over the prehearing conference. The prehearing conferences could be held either in person or by telephone conference call, and are designed to help the parties to reach agreement on such matters as the exchange of information, exchange or production of documents, identification of witnesses, identification and exchange of hearing documents, stipulations of fact, identification and briefing of contested issues, and any other matter which will expedite the arbitration proceedings.

When a prehearing conference is unable to resolve any of these issues, NYSE Rule 619(e) provides for the director of arbitration to appoint a single arbitrator to decide the issues outstanding. In its filing, the NYSE stated that the rule allows the arbitrator to issue subpoenas, direct appearances of witnesses, direct the production of documents and depositions, and set deadlines and issue any other ruling which will expedite the hearing and permit any party to develop fully its case. The AMEX and NASD have amended their filings to provide that the single arbitrator appointed to decide prehearing matters would be a public arbitrator in those cases where public customers have requested a majority of public arbitrators for their panel. Staff at the NYSE has confirmed that it will recommend that its governing board adopt this amendment to its rules this year.

Other amendments to the prehearing provisions require parties to serve on one another at least ten days prior to the first hearing copies of documents in their possession that they intend to present at the hearing and identify witnesses they intend to present at the hearing. Under proposed NYSE Rule 619(c), arbitrators may exclude from the arbitration, documents not exchanged or witnesses not identified at that time. The provision does not extend to documents or witnesses that parties may use for cross-examination or rebuttal.[90] In addition, the SROs are proposing to amend their rules regarding subpoenas. In NYSE Rule 619(f), the NYSE proposes to require parties to serve copies of all subpoenas on all parties.[91]

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[28] In its explanation of this provision of the discovery rule, the NYSE stated that the arbitrator appointed to resolve discovery disputes "may issue subpoenas, direct appearances of witnesses, direct the production of documents and *depositions*, and set deadlines and issue any other ruling which will expedite the hearing and permit any party to develop fully its case." (emphasis added) In addition, the training manual for arbitrators developed by the NASD, AMEX, NYSE and other members of SICA specifically contemplates, at page 8, the ability of arbitrators to order depositions. Accordingly, we understand the language in all of the SRO rule filings included within this approval order to be broad enough to encompass the ability of a single arbitrator or panel of arbitrators to exercise their discretion to order depositions. Since arbitrators' jurisdiction is limited, the ability to enforce arbitrators orders for depositions of non-parties or of persons not affiliated with a member of the sponsoring SRO may depend upon whether relevant arbitration law provides for depositions in aid of arbitration.

[29] AMEX Rule 607 and NASD Section 32 address the discovery issues addressed in NYSE Rule 619.

Public Citizen, PELA, and SIA, Shearson and Jeffrey Bauer, Esq. ("Bauer") [92] commented on the proposed amendments to the prehearing provisions. Public Citizen expressed support for the proposals but stated its view that the proposals do not go far enough to provide investors with adequate discovery.[93] Public Citizen and PELA commented that restrictive discovery favors the industry over investors in light of their view that broker-dealers are more likely to have documents and other information necessary to prove a case against the firm, and the fact that a claimant has the burden of proof.[94] PELA commented that parties should have a right to depositions. Public Citizen suggested that it would be reasonable for parties to be able to have one or two depositions in a case. In effect, Public Citizen called for parties to have access to depositions where "necessary to develop [one's] case, and [where one] cannot obtain equivalent information from documents alone * * *"

The SIA stated that it does not object to arbitrators ordering the depositions of non-party witnesses who are unable to attend the hearing. The SIA expressed concern that depositions not be used to delay the proceedings, but stated that the proposed rule is sufficiently flexible to permit arbitrators to order depositions to allow parties to develop fully their cases.[95] Shearson supported the "strengthening of the discovery process." Shearson stated that the proposed rules will "further enhance investor confidence in the system" and do not "attempt to incorporate excessive litigation procedures and inordinate delays into" the arbitration process.

The Commission believes that the SRO discovery rule proposals should increase the efficiency of arbitration proceedings and provide substantially greater protections for public participants. Provisions requiring parties to notify one another of subpoenas and of witness and document lists all move away from surprise at the hearings and towards the goal of reaching fair and accurate resolutions of disputes. We believe that the timetables imposed in these rules set necessary discipline to preserve the speedy nature of arbitration, properly provide impetus for the parties to make initial efforts to work out discovery disputes and, accordingly, are in the public interest.

The language in the rule providing for the ability of an arbitrator acting as a single arbitrator to issue any "ruling which will expedite the arbitration proceeding or is necessary to permit any party to develop fully its case" substantially meets the concerns expressed by Public Citizen regarding the ability of investors to obtain depositions. The NYSE's explicit recognition that this provision includes the ability of arbitrators to order depositions, the new training manual developed by SICA, and the comment of the SIA that the rule as now drafted permits the arbitrators the discretion to order a deposition where a party can demonstrate to the arbitrators that a deposition is necessary to develop a case all support this view.[96]

The concern over excessive use of depositions is not frivolous. This concern should not be permitted, however, to avoid the proper use of depositions. The Commission's approval of this portion of the discovery rule is based on our clear understanding that depositions will now be available as a matter of routine to parties in appropriate cases. This rule grants parties access to depositions to preserve the testimony of ill or dying witnesses, or of persons who are unable or unwilling to travel long distances for a hearing, as well as to expedite large or complex cases, and in other situations deemed appropriate by the arbitrators. These rules make an appropriate choice in our view, by leaving to the arbitrators' judgment the need for depositions and other discovery. SICA and the individual SROs can evaluate the implementation of these rules, and to the extent necessary, expand discovery available as of right or impose sanctions for the failure to comply with time frames established under the new procedures. In that connection, we expect the SROs to monitor the use of depositions in arbitrations administered under their auspices, and to track arbitrators' action on requests for depositions.

The Commission believes that the rule proposals promote the purposes of the Act in aiding investors to discover the documents and other information they need to prove their cases. If experience with these rules suggests that arbitrators need additional authority to manage these proceedings, we are confident that SICA and the SROs will move to adopt them.

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[90] The NYSE proposes to delete the provisions of NYSE Rule 628, which paralleled this provision in certain respects.

[91] The AMEX and NASD have placed the provisions dealing with subpoenas and the power of arbitrators to direct appearances and production of documents in separate rules consistent with the Uniform Code. (AMEX Rules 610 and 611, and NASD Section 33) The NYSE proposal incorporates these provisions into its discovery rule. There is no substantive difference between the proposals.

[92] *See* letter from Jeffrey Bauer, Esq. to Howard Kramer, Assistant Director, SEC, dated February 10, 1989. Bauer is a securities and commodities attorney.

[93] Public Citizen also questioned whether the rules on discovery apply to small claims proceedings (up to $10,000) administered under simplified procedures, because such cases may be conducted without an oral hearing. NYSE Rule 601(1), AMEX Rule 621(1) and NASD Section 13(1) make it clear that unless otherwise provided, the general arbitration rules apply to all cases, under both the simplified and regular procedures, and, accordingly, the discovery rules apply to the simplified procedures, without regard as to whether there is an oral hearing or simply a hearing on the papers.

[94] Bauer expressed the concern that the discovery provisions (as well as other provisions that contain time frames, such as those dealing with the submission of pleadings) do not contain specific sanctions for failure to meet time frames. He commented that arbitrators ought to have the ability to assess fines or costs against parties who do not meet the time frames in the rules.

[95] The SIA also raises a question concerning the effect of the inclusion in NYSE Rule 619, entitled GENERAL PROVISION GOVERNING PRE-HEARING PROCEEDING, of the provision of former NYSE Rule 620 regarding the ability of arbitrators to direct the appearance of persons associated with a member or the production of records in the possession or control of such persons. The SIA expressed concern that the repositioning of the rule might have the effect of granting the single arbitrator assigned to resolve prehearing issues the additional ability to require industry personnel to appear before the single arbitrator prior to the hearing. Arbitrators have that authority under both versions of the rule.

There is nothing in either the Uniform Code or the NYSE's rule that would preclude an arbitrator from ordering the appearance of an employee of an SRO member prior to the initial hearing on the merits. It is appropriate that arbitrators have this flexibility under the rules. Both the AMEX and the NASD retained their provisions regarding the ability of arbitrators to direct appearances of persons and documents in separate rules, as does the Uniform Code. In the Commission's view, neither placement affects the meaning of the provision, and the language of the balance of the prehearing provisions makes it clear that an arbitrator acting as a single arbitrator under the rule may direct appearances of witnesses and the production of documents. Likewise, the NYSE's placement of this provision does not restrict the ability of the full arbitration panel to order the appearance of witnesses or production of documents at the hearing, notwithstanding the caption for the rule.

[96] There are differences in the text of the NASD rule concerning the ability of a single arbitrator to issue orders before a hearing from the text of the NYSE and AMEX rules. The NASD has not yet amended its rule to include the language "or is necessary to permit any party to develop fully its case." In a letter from Frank J. Wilson, Executive Vice President and General Counsel, NASD, to Catherine McGuire, Special Assistant to the Director, SEC dated April 18, 1989, the NASD stated that before it can conform its rule to the NYSE and AMEX rules, this language must be considered and approved by the NASD National Arbitration Committee and Board of Governors. In the interim, there should be no negative inference from this omission in the NASD's rule. In a letter from Frank J. Wilson to Catherine McGuire, Special Assistant to the Director, SEC dated April 18, 1989, the NASD acknowledged that arbitrators have authority under various statutes to exercise the discretion to order depositions of persons who are unable or unwilling to attend hearings.

G. Preservation of a Record

NYSE Rule 623 would codify a requirement that a verbatim record by stenographic reporter or tape recording be maintained.[37] The rule further provides that if a party to a proceeding elects to have the record transcribed, the cost of such transcription shall be borne by that party unless the arbitrator(s) direct otherwise. If a record is transcribed at the request of a party, the rule requires that a copy shall be provided to the arbitrators.

In its September 10, 1987 letter, the Commission requested that SRO arbitration departments amend their rules to assure that records of arbitration proceedings are made and preserved. These records are necessary for courts to use in conjunction with any review of the proceedings they may make. The September letter suggested that records be made either with high quality tape recordings, or by engaging a court reporter to record testimony, which can later be transcribed on request. The Commission believes that the SRO proposals would assure the preservation of a record of each arbitration proceeding and therefore facilitate an appropriate court review.

H. Content and Public Availability of Arbitration Awards

The SROs' proposed rule for arbitration awards expands both the content and public availability of arbitration awards. Proposed NYSE Rule 627 provides that awards shall contain the names of the parties, a summary of the issues in controversy, the damages and/or other relief requested, the damages and/or other relief awarded, a statement of any other issues resolved, the names of the arbitrators and the signatures of the arbitrators concurring in the award.[38] The awards, including any written opinion voluntarily prepared by the arbitrators, are to be made public, except that the names of customer parties to the arbitration will be excluded if the customer parties request in writing that their names not be included on the public version of the award.[39]

The Commission requested such a rule in its September 1987 letter. Prior to the proposals made in this filing, the only information available to the public regarding SRO arbitration cases was the percentage of investors that received some portion of the amount they claimed against their broker-dealer. No data has been available with respect to particular arbitrators' awards. The proposal developed by SICA affords substantially more public access to the results of this process of dispute resolution.

Six of the commenters, Public Citizen, PELA, the SIA, Shearson, Richard Ryder, Esq. ("Ryder") [40] and Bauer, commented on the proposals for arbitration awards. Public Citizen and PELA called for the awards to include written decisions that include the arbitrators' reasons for their awards. Public Citizen commented that the verbatim records of the hearings are insufficient for a court to apply the "manifest disregard" standard [41] in the review of an arbitration award, and that a court must know arbitrators' reason in order to apply the standard. In this respect, Public Citizen expressed its preference for the traditional, judicial adherence to precedent over the more *ad hoc* factual determinations it stated were contemplated in these arbitration proposals. Public Citizen also commented that reservations expressed by SICA in its response [42] to the Commission's September 10, 1987 letter with respect to the ability of arbitrators to capture in an opinion the consensus process of arbitrators, were strained, and in its opinion were directed at concerns that flaws in the decisionmaking process would be exposed to challenge in the courts if arbitrators' rationales were known.

PELA stated that legal issues are often dispositive in employment cases between broker-dealers and registered representatives, and that these issues differ from state to state. Therefore, PELA commented, written opinions would be necessary in order to make decisions about whether to appeal arbitral awards.[43]

After careful consideration of whether awards ought to include reasons for arbitrators' awards, as is advocated by Public Citizen and PELA in their comment letters, we have concluded that it would not be appropriate at this time to require the inclusion of written opinions in awards.

This rule change already represents a significant movement in the explication of the arbitral process. We believe that it would be in the public interest to allow the SROs and parties a period of time to adjust to this rule, and to await any independent development on the part of the arbitrators themselves to develop written opinions. In the labor area, arbitrators have voluntarily developed a practice of writing opinions in order to help themselves understand developments in the labor arena.[44] The opinions were not mandated and were not developed to enable courts to review arbitral decisions.[45]

We also believe that there is merit in the arguments proffered by SICA with respect to the process of consensus that often may precede the reaching of a decision. Arbitrators may ultimately reach agreement on an award, a dollar amount, without ever reaching agreement on the reasons for the award. Finally, the Commission is concerned that imposing a mandatory requirement for written opinions at this time could slow down the arbitration process and discourage many persons from participating as arbitrators. At present, we do not believe that the benefit obtained from requiring written decisions outweighs these concerns.[46]

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[37] AMEX Rule 614 and NASD Section 37.

[38] AMEX Rule 616 and NASD Section 41.

[39] In the NASD's version of the award rule, Section 41 of its Code of Arbitration procedure, investors do not have the option of excluding their names from the public version of the award. In addition, the NASD's proposal would exclude the arbitrators' names from the public version of the awards. Instead, the NASD proposes to make available upon request to parties in a particular arbitration matter, full copies of all awards rendered by the arbitrators chosen to decide their case. The NASD proposal also requires parties to request the proposed arbitrators' previous awards within three days of having been notified of the persons to serve on the panel.

[40] *See* letter from Richard Ryder, Esq. to Jonathan G. Katz, Secretary, SEC, dated February 14, 1989. Ryder is the publisher of a newsletter on securities and commodities arbitration.

[41] *See, Merrill Lynch, Pierce, Fenner & Smith v. Bobker*, 808 F.2d 930 (2d Cir. 1987).

[42] *See* letter from the Securities Industry Conference on Arbitration to Richard G. Ketchum, Director, Division of Market Regulation, SEC, dated December 14, 1987.

[43] PELA also commented that arbitration panels may have no lawyers or only defense lawyers and that "[i]n many cases, arbitration counsel (actually an employee of the NASD) told the arbitrators what the law is. This is unacceptable and fundamentally unfair." The letter further commented that legal advice by SRO staff, including training materials, should be on the record. It stated "[l]itigants simply have the right to know what the arbitrators are told by outsiders about the law that is to be applied." Although this comment does not directly address any of the rule proposals before the Commission, the conduct described by PELA, if it actually occurs, would be unfair, and unacceptable in SRO arbitration. The SROs have assured the Commission that SRO staff is not permitted to advise abritrators on the law. Further, all training materials are available to the public.

[44] *See, e.g.*, Jennings and Martin, The Role of Prior Arbitration Awards in Arbitral Decisions, Labor Law Journal (February 1978).

[45] Even if awards contained errors of law, it is important to recall that under applicable law, a mistake of law is not currently grounds for vacating an arbitration award.

The error must have been obvious and capable of being readily and instantly perceived by the average person qualified to serve as an arbitrator. Moreover, the term "disregard" implies that the arbitrator appreciates the existence of a clearly governing legal principal but decides to pay no attention to it.

Bobker, at 933. The data already included in the awards under this proposal together with the pleadings and the verbatim record of the case ought to be sufficient in making determinations under the current manifest disregard standard.

The SIA, Ryder and Bauer expressed different concerns with respect to the SRO's proposals regarding awards and stated that various portions of the proposal are problematic, and may not be of much use to prospective parties. The SIA stated that it believes that knowledge of past awards may not be helpful to the parties in their evaluations either of particular cases or arbitrators. Because the arbitral awards are typically the product of a consensus of the views of arbitrators, the SIA argues that it is unlikely that an award for which an arbitrator voted would necessarily reflect the specific views of that arbitrator, but rather only the product of compromise between the members of the panel. The SIA further commented that these awards would be unlikely to be accurate indications of the voting records of arbitrators because cases tend to be fact intensive, and therefore each case unique. The SIA also expressed some concern over the summaries to be prepared of each case. It stated that summaries are likely to be subjective and would vary among the SROs. The SIA stated its opinion that SRO staffs would be likely to draft these, which could result in characterizations with which parties would not concur. The SIA suggested that claimants be required to supply the summaries. Shearson, in contrast, stated that the rules regarding the contents and public availability of arbitration awards will further enhance investor confidence in arbitration without excessively burdening the process.

Making awards publicly available is in our view very significant to promoting investor confidence in the arbitration system. Clearly, awards rendered by arbitrators in prior cases will not predict the vote or outcome of future cases. The awards will, however, provide greater public understanding of the arbitration process.[47] Moreover, while the Commission cannot evaluate the strategic value of information regarding past awards in which a particular arbitrator participated, we note that some of this historic information has been compiled by individual industry participants for their own cases. Investors, who are typically one time users of the arbitration system, do not have access to any such information. The Commission believes that it is preferable for information on past arbitrations to be equally available to all parties.

Ryder commented that arbitrators' names should not be available to the public. He stated that because the arbitrators are not professional arbitrators, but rather volunteers, they should not be exposed to public criticism for unpopular awards, such as, for example, a case where an industry arbitrator voted for punitive damages to be awarded against a broker-dealer or its employees. He also stated that publication of arbitrators names would be likely to encourage the media to contact arbitrators to discuss a particular case, in conflict with the general practice of arbitrators not to discuss cases on which they have served, and without the protection of arbitrators' immunity. This he believes would expose arbitrators to criticism and discourage them from serving. He further argues that this is weighed against limited insight to be gained from the review of the one or two arbitral awards typically rendered per year by an arbitrator, which may not be a probative sample. He commented that at a minimum, the Commission should approve only the NASD approach to awards, which would disclose arbitrators' names only to parties in specific cases.

The Commission believes that Ryder overemphasizes the pressure that may be brought to bear upon arbitrators whose names are made public, either by the press who seek to discuss an award or by members of the community with respect to unpopular awards. We expect that arbitrators are sufficiently competent and resolved to abide by their obligations not to discuss cases. Individual SROs have submitted different proposals regarding how widely they will disclose the names of arbitrators for particular cases. Both choices appear reasoned with proper consideration for the needs of the parties, the public and the arbitrators. As the SROs gain experience with these new procedures, one version or the other may develop as clearly preferable. We see no reason to disturb the discretion of the SROs on this point.

Ryder also questions the fairness under the rule proposals of the NYSE and AMEX of requiring the public disclosure of industry parties to an arbitration, but not of the investors' names. Resolution of disputes between investors and broker-dealers has a public as well as private purpose. It is important for the public to be aware of the number and nature of allegations against broker-dealers registered with the Commission and their employees. To the extent that individual investors choose to keep proceedings regarding their private finances shielded from public secrutiny, then the traditional notions of privacy in arbitration are not inappropriate, and should be preserved. The potential embarrassment to securities employees as a result of claims in arbitration proceedings of misconduct or error, however, is subservient to the public's need to know about these cases.

Ryder also suggests that the awards contain more information relating to the date of the arbitration filing; the city in which the hearings took place; the number and date of the hearings; the names of the attorneys who represented the parties, if any; the primary product or investment vehicle involved in the dispute; and the date the award was rendered. He stated that this information would be relatively simple to include and would better permit vendors of the information in arbitration awards to analyze the efficacy and speed of arbitral awards. He also suggests that the resulting data would be useful for case settlement, brokerage house compliance efforts, and regulatory oversight.

In response to these suggestions the SROs have amended their filings to include data he suggested, including the dates the claim was filed and the award rendered, the number and dates of hearing sessions and the location of the hearing(s). The type of investment vehicle involved is likely to be included already in the summary of the issues in controversy. The SROs have determined not to include at this time the names of the parties' counsel in the awards. The Commission does not believe that the disclosure of the parties' counsels' names would provide significant benefit to persons in the arbitration process. Accordingly, we believe that the SRO proposals in their amended form are consistent with the Act.

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[46] We also anticipate, however, that SICA will soon renew its consideration of issues important to the successful administration of large and complex cases. It may be appropriate to provide for written opinions for such cases.

[47] We also disagree with the SIA's assumption that these summaries will likely be prepared by SRO staff and will become subject to criticism by the parties. Our understanding is that awards will be the responsibility of the arbitrators, and that they will represent the arbitrators' understanding of the issues in controversy. If draft awards are prepared by SRO staff, they are under the supervision of the arbitrators and subject to arbitrators' review and approval.

I. Arbitration Fees

The SROS have also clarified through these rule filings the potential fees to parties of pursuing a case through SRO arbitration. The arbitration fee proposals represent significant increases in the fees that may be assessed by the arbitrators for particular cases.

The definition of a "hearing session" has been clarified in the proposal. A hearing session under proposed NYSE Rule 629(b) [48] would be a meeting between the parties and arbitrators that lasts less than four hours. For the AMEX, which previously considered a hearing session to be a full day of hearings, the proposal increases the fees that may be assessed against a party. The NASD changed its practice with respect to the assessment of fees, from a full day to a half day, in June of 1987 resulting in a similar fee increase. This filing fulfills the NASD's obligation pursuant to Section 19(b) and Rule 19b–4 to file a rule change with the Commission in light of its change in policy.

Proposed NYSE Rule 629(d) also would raise to $200 from $100 the minimum deposit for cases where no money damages are claimed. Proposed NYSE Rule 629(h) and AMEX Rule 620(h) set a fee for prehearing sessions with an arbitrator of seventy-five percent of hearing session fees.[49] Further, proposed NYSE Rule 629(a) of the filing proposes that all parties who file claims, such as counterclaims, cross-claims and third party claims, now should be required to pay deposits. Under the existing rules, deposits are required only of original claimants. This significantly increases the potential fees that may be recovered by the SROs and assessed against a party since arbitrators may assess costs against a single party.

Proposed NYSE Rule 629(c) also clarifies that arbitrators may assess the costs of conducting a hearing against the parties as they deem appropriate. These costs include not only the fees for each session, but all other costs of conducting the hearing contemplated under the rules, such as the costs of transcribing a record, or producing witnesses or documents, and any other cost contemplated by the agreement between the parties or permitted by applicable law.

Two commenters, PELA and the SIA, wrote regarding the appropriateness of the fee increases in the proposals. PELA, without being specific, stated that the fees increases are an unfair barrier to dispute resolution. The SIA commented that the fees probably are appropriate, in light of the facts both that the SROs continue to subsidize the forum to a substantial extent and that the fees are, in its view, lower than for other arbitration forums.

The Commission believes that these arbitration fee increases are justified on the basis of the rule's deference to the ability of the arbitrators to allocate fees and forum costs fairly among the parties. None of these fees are automatically imposed on either party. The SROs also have advised the Commission that the fees collected in recent years are a relatively small portion of the cost of administering their programs.[50]

We intend to monitor the future administration of this rule closely. Costs to investors for SRO arbitration historically have been low, and must remain so. The application of these fees should not be permitted to operate in a manner that weighs too heavily on individual parties or serves as a disincentive to pursuing the redress of investors' grievances against broker-dealers or their associated persons.

We conclude that in light of the costs of administering the arbitration programs and the need for continued SRO subsidies, and the role of the arbitrators in allocating fees in each case, the fee increases appear to be reasonable and the procedure for allocating them provide for an equitable allocation consistent with Sections 6(b)(4) and 15A(b)(5).

J. Predispute Arbitration Clauses

The SROs, through the auspices of SICA, developed two rule changes designed to improve disclosure to customers in account opening agreements,[51] and to restrict the content of the arbitration clauses.[52]

The proposals would require broker-dealers that employ predispute arbitration clauses to place immediately before the clause introductory language that would inform customers that they are waiving their right to seek remedies in court, that arbitration is final, that discovery is generally more limited than in court proceedings, that the award is not required to contain factual findings and legal reasoning, and that the arbitration panel typically will include a minority of arbitrators associated with the securities industry.

The proposal requires that the disclosure language be highlighted four ways. First, large or otherwise distinguishable type must be used. Second, the disclosure language must be set out in outline form so as to be noticeable to readers. Third, a statement, also highlighted, that provides that the agreement contains a predispute arbitration clause, and where that clause is located in the contract, must be inserted into the agreement immediately preceding the signature line. Fourth, a copy of the agreement containing a predispute arbitration clause must be given to the customer, who is to acknowledge receipt of the agreement, either in the agreement itself or in a separate document.[53]

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[48] AMEX Rule 620 and NASD Section 43

[49] The fee for prehearing sessions with an arbitrator under NASD Section 43 is the same as the fee for hearing sessions.

[50] For example, the NYSE has advised us that its costs for administering its arbitration program, excluding rent allocation, for the years 1987 and 1988 were $1,987,000 and $2,893,000, respectively. It recovered $780,000 in 1987 and $1,264,000 in 1988 through the arbitrators' assessment of fees. The NASD reported that its costs for fiscal year 1986–1987 were $4,968,072 and for fiscal year 1987–1988 were $7,086,344, while it recovered in fees $402,543 in fiscal year 1986–1987 and $1,342,414 in fiscal year 1987–1988. The AMEX reported that its costs, excluding rent allocation, for 1987 and 1988 were $183,500 and $187,100, respectively, while it recovered in fees $46,780 in 1987 and $46,380 in 1988.

[51] On July 8, 1986, the Commission sent to all SROs that administer arbitration programs a letter requesting that they examine issues surrounding their members' use of predispute arbitration clauses. The letter followed a study by the Commission staff of 88 broker-dealer firms that account for approximately 90% of all customer trading accounts in the United States. Ninety-six percent of the margin accounts, 95% of the options accounts and 39% of the cash accounts at those firms at the time of the study were subject to predispute arbitration clauses. At least five of the nation's largest broker-dealers, with offices around the country, currently do not require the signing of account agreements for individual cash accounts that do not otherwise require documentation in connection with other services provided in the account, such as individual retirement accounts or trustee controlled accounts. For example, Merrill Lynch, PaineWebber, A.G. Edwards, Dean Witter, and Kidder Peabody do not require an individual to sign an account agreement for such cash accounts.

[52] NYSE Rule 637, AMEX Rule 627 and Article III, Section 21 of the NASD's Rules of Fair Practice.

[53] The version of the rule as developed by SICA includes a provision that requires that customers initial the statement advising investors that the contract contains an arbitration clause. In comments received by SROs from their members before these filings were submitted to the Commission, SRO members argued against the initialling requirement, stating that the initialling proposal would create operational difficulties (where investors had not initialled) without providing any corresponding additional investor protection. These firms also expressed concern over the legal significance of the initialling provision. None of the SROs has included the initialling provision in its submission to the Commission.

The proposal also prohibits SRO members from having agreements with customers that limit or contradict the rules of any SRO or limit the ability of a party to file any claim in arbitration or limit the ability of the arbitrators to make any award.

Four commentators, Public Citizen, PELA, the SIA and Shearson, commented on the provisions relating to the use of predispute arbitration clauses. Public Citizen welcomed the improvement to the system for notifying investors about the existence and effect of arbitration clauses, but stated that the proposed rules are inadequate for the protection of investors. Public Citizen's preferred result would be a rule flatly prohibiting broker-dealers from limiting or conditioning access to brokerage services on the signing of a predispute arbitration agreement.[84] Accordingly, Public Citizen comments that, at a minimum, investors should receive notice when presented with a predispute arbitration clause that they are receiving nothing in return for signing the arbitration agreement. Public Citizen reasons that as public customers already have the right under SRO rules to demand that their broker-dealers and registered representatives arbitrate any dispute that may arise, the arbitration clause creates obligations only for the customers. Consequently, Public Citizen states that SICA's initialling provision [85] should be adopted by the SROs in order to assure "that [public customers] at least [are] aware of the fact that they are agreeing to such a one-sided arrangement, and expressly signal their approval of it." Public Citizen also adds that consideration, in the form of discounted commission rates, should accompany any agreement to arbitrate.

Both the SIA and Shearson endorsed the concept of disclosure regarding the arbitration clauses contained in the proposals. The SIA commented that a disclosure approach is appropriate with respect to the clauses, while additional choice would presume that there was something wrong with arbitration, counter to the Federal Arbitration Act.[86]

The disclosure provisions set out in the new rule address many of the concerns regarding customer notice and choice that have been considered over recent years in open Commission meetings, the courts, and in hearings before the House Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce. All new arbitration agreements will be required to contain clear and highlighted disclosures alerting investors to the meaning of the arbitration contracts they are signing. This, in turn, we anticipate should promote more knowledgeable acquiescence or rejection by customers of arbitration provisions. The combined effect of the newly mandated disclosures and the notice immediately prior to the signature line, advising investors of the existence and location of the arbitration clause, will sufficiently focus any reader of the customer agreement to the arbitration provisions.

In that connection, we are unable to conclude that the marginal benefits to investors of mandating that there be a separate initialling of the provision pointing to the existence of the arbitration clause, on top of the multiple disclosures already being mandated warrant overruling SRO judgment as to the costs and operational burdens on members of such a requirement.

The Commission believes that the new provision in the rule prohibiting firms from including in their agreements any condition which limits or contradicts the rule of any SRO [87] or limits the ability of a party to file any claim in arbitration or limits the ability of the arbitrators to make any award benefits investors. This provision makes clear that the use of arbitration for the resolution of investor/broker-dealer disputes represents solely a choice of arbitration as a means of dispute resolution. Agreements cannot be used to curtail any rights that a party may otherwise have had in a judicial forum. If punitive damages or attorneys fees would be available under applicable law, then the agreement cannot limit parties' rights to request them, nor arbitrators' rights to award them. The agreements may not be used to shorten applicable statutes of limitation, restrict the situs of an arbitration hearing contrary to SRO rules, nor to limit SRO forums otherwise available to parties.

The Commission has concluded that approval of this rule, which does not include provisions mandating customer choice with respect to the signing of arbitration clauses, is consistent with the Act. Under the circumstances presented, the Commission is reluctant to dictate the terms of a fully disclosed agreement between a broker-dealer and a customer. Investors currently have access to basic brokerage services without agreeing to pursue any future disputes through arbitration, rather than through the courts. This is so because a number of broker-dealers, including several large full-service broker-dealers in the country, do not require the signing of account agreements for cash accounts.[88] The Commission recognizes that investors do not have such access with respect to margin and options accounts, but observes that with respect to margin accounts, the firms' separate lending relationship with the customer may increase the desirability of agreeing in advance that disputes will be resolved through arbitration. Moreover, the Commission believes that the improved disclosure provided in the rules will effectively alert investors as to the consequences of signing predispute arbitration clauses. To the extent that a class of investors emerge who object to predispute arbitration agreements, the Commission is hopeful that competitive forces will result in some firms offering margin or options accounts without such agreements. Additionally, pricing strategies may arise that provide for different rates to be charged to customers who do not agree to predispute arbitration provisions. The Commission, however, will carefully monitor the effectiveness of the SRO disclosure provisions as well as any increased usage of predispute arbitration agreements for cash account customers.

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[84] PELA also called for a prohibition of mandatory arbitration. Its letter is principally directed at broker-dealer/employee cases and thus addresses issues different than those being considered by the Commission in these proposals. PELA considers the amendments represented in these filings, without greater employee/investor choice, and without procedures more like the courts, to be merely cosmetic.

[85] *See* footnote 53.

[86] Public Citizen also commented that the SROs should submit a rule establishing procedures for class action litigation and joinder provisions. Public Citizen suggests that such procedures would permit parties to resolve collectively "repeated patterns of statutory violations that simply are not worth individual investors time and resources to pursue." In testimony on July 12, 1988 before the House Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, SEC Chairman David Ruder addressed the need for the SROs to consider special procedures, or the declination of jurisdiction over class action litigation.

The SROs' arbitration rules already include provisions allowing for the joinder of claims. The SROs are improving the guidance provided to arbitrators with respect to their existing ability, under the arbitration rules to refer certain cases back to the courts. The arbitration agreements of the parties include the obligation to abide by the arbitration rules, which provide that arbitrators may refer parties to their remedies at law, and that SROs may decline to accept jurisdiction over a particular case.

Although no SRO rule has been submitted, SICA is considering a policy whereby all SROs will decline jurisdiction over class action litigation unless the class certification and representation issues have first been resolved by a court of competent jurisdiction. At that time, under the SROs' existing rules, both the SROs and the arbitrators for a particular case may determine whether the facilities of the SRO are adequate to handle the litigation, or whether parties should be referred to their remedies at law.

[87] This part of the proposed rule change is a clear statement of existing law. *See generally*, sections 6(b), 15A(b), 19(g) and 29 of the Act, and NYSE Arbitration Rule 600(a), Article VIII, Sections 1 & 2 of the AMEX Constitution, and section 12(a) of the NASD's Code of Arbitration Procedure.

[88] *See* footnote 51 *supra*.

IV. Conclusion

The Commission welcomes the changes in SRO arbitration heralded by these proposals, and the cooperative effort that produced them. These rules represent several years of effort by SICA. They represent the promise of the SROs to maintain fair and efficient forums for the arbitration of disputes between members and investors. The Commission believes that the proposed rules appropriately balance the need to strengthen investor confidence in the arbitration systems at the SROs, both by improving the procedures for administering the arbitrations and by creating clear obligations regarding the use by SRO members of predispute arbitration clauses, with the need to maintain arbitration as a form of dispute resolution that provides for equitable and efficient administration of justice.[59]

In particular, the rule changes affecting the classification of arbitrators, arbitrator disclosure, discovery, the preservation of a record, the form and public availability of awards, and guidelines for the use of predispute arbitration clauses dynamically advance the public interest in SRO arbitration. Likewise, the SROs' initiatives with respect to the handling of pleadings, appointments of replacement arbitrators, the use of small claims procedures, and the number of arbitrators should improve the efficiency and speed of arbitration, maintaining those bargained for qualities of traditional arbitration. Because these rules will aid in the just resolution of disputes between investors and broker-dealers, we conclude that these rules are designed to prevent fraudulent and manipulative practices, promote just and equitable principles of trade and in general, protect investors and the public interest consistent with sections 6(b)(5) and 15A(b)(6). The fee increases represented by these changes appear to be reasonable and provide for an equitable allocation of fees among SRO members and investors using the arbitration facilities consistent with sections 6(b)(4) and 15A(b)(5).

Accordingly, the Commission finds that the proposals submitted by the NYSE, NASD and AMEX are consistent with the requirements of the Act, specifically sections 6(b) (4) and (5) and 15A(b) (5) and (6), which require that national securities exchanges and registered securities associations have rules designed to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, provide for an equitable allocation of fees, and, in general, protect investors and the public interest.[60]

It is therefore ordered, Pursuant to Section 19(b)(2) of the Act, that the above mentioned proposed rule changes be, and hereby are, approved.[61]

By the Commission.

Jonathan G. Katz,

Secretary.

Dated: May 10, 1989.

[FR Doc. 89–11723 Filed 5–5–89; 8:45 am]

BILLING CODE 8010–01–M

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[59] Public Citizen also suggested in its July 15, 1988 letter that the Commission should have used its authority under section 19(c) of the Act [15 U.S.C. 78s(c)] to institute the changes to the SROs' arbitration rules, rather than by recommending changes as was done in our September 10, 1987 letter. The September 1987 letter was not, and should not be viewed as, a formal invocation of Commission rulemaking. As the Commission staff stated in its reply to Public Citizen, the letter was the result of the staff's review of SRO arbitration pursuant to the Commission's responsibilities under sections 17 and 19 of the Act [15 U.S.C. 78q and 78s]. (*See* letter from Catherine McGuire, Special Assistant to the Director, SEC, to Eric R. Glitzenstein and Alan B. Morrison, Public Citizen, dated January 27, 1989.) Moreover, the September 1987 letter identified areas where the Commission believed that improvements were needed, but did not itself make specific rule proposals.

Open and continuous dialogue with the SROs on all matters, including the need to consider regulatory changes, is essential to the working of the scheme of self-regulation established by Congress. This process has included significant public dialogue, and all commentators' views, including those expressed by Public Citizen, have been considered in the context of these rule filings pursuant to Rule 19b–4.

[60] The Commission finds that there is good cause to approve the proposed amendment to Article III, section 21 of the NASD's Rules of Fair Practice prior to the thirtieth day after the date of publication of notice of filing in the Federal Register. The NASD published a substantially similar draft of this rule for its members' comment on November 1, 1988. NASD members, in a vote concluding on April 3, 1989, voted 1,471 in favor of the proposed rule, and 237 for disapproval. In addition, the NYSE's and AMEX's versions of the same rule were published for public comment in the Federal Register on January 26, 1989, providing the public with ample opportunity to comment on the proposed rule change.

[61] The proposed rule changes to NYSE Rules 607, 608, 610, 611, 618, 620 and 627; AMEX Rules 602, 603, 607, 608, 610, 614, 618, 621 and 622; and NASD Sections 21, 23, 32, 37, 41 and 46 are effective upon approval. The proposed rule changes to NYSE Rules 601, 612 and 630; AMEX Rules 606 and 630; and NASD Sections 8, 13, 19, 25, and 43 are effective only for cases filed with the SROs after this approval. The proposed rule change to NYSE Rule 637, AMEX Rule 427 and Article III, Section 21 of the NASD's Rules of Fair Practice will become effective September 13, 1989.

EXHIBIT B

SUMMARY OF STAFF FINDINGS WITH RESPECT TO THE USE OF PREDISPUTE ARBITRATION CLAUSES

SUMMARY OF STAFF FINDINGS WITH RESPECT TO THE USE OF PREDISPUTE ARBITRATION CLAUSES

The staff of the Division of Market Regulation ("Staff") examined 65 broker-dealers to learn their current practices and policies with respect to the use of predispute arbitration clauses for retail customers. 1/ The staff examined 25 of the largest New York Stock Exchange ("NYSE") member firms as well as the 20 largest member firms of the National Association of Securities Dealers, Inc. ("NASD") that do not also belong to the NYSE, and a cross section of other NASD firms (these last two groups of firms are referred to collectively as the "NASD" or "NASD member" firms).

Below is a statistical profile of predispute arbitration clause use in retail margin, options and cash account agreements. The business and customer profile of the 65 firms examined varies somewhat. Eleven NASD firms examined do not have margin accounts and at least six of those firms do not have retail customer accounts. Therefore the computations of percentages in the statistical analysis are based on the universe of those firms that have such accounts. In addition, some firms provided information on their policies with respect to the use of predispute arbitration clauses, but did not provide data on the number of accounts they had. Therefore, percentages and account number totals refer to the data provided in response to the examinations. Exhibit B sets out summary profile information on the firms' accounts and use of predispute arbitration clauses.

1/ These examinations were conducted by letter. A sample of the written examination sent to each firm is attached as Exhibit A.

In its examination, the staff did not specifically ask the firms about their use of predispute arbitration clauses with institutional clients. Nevertheless, the responses to the examinations provided some information concerning the treatment of institutional clients. For example, two firms do not include arbitration clauses in their standard contracts with institutional clients, while they do for retail customers. Two other firms prefer but do not insist on predispute arbitration clauses with institutional clients, while yet another permits the deletion of the arbitration clause for some institutional clients.

The following table sets out a summary of the current use of predispute arbitration clauses in retail accounts with the sixty-five broker-dealers examined. The chart summarizes data by type of account and shows the number of firms examined with predispute arbitration clauses and what percentage of the accounts reported on in the examinations 2/ are covered by the clauses. 3/ The data concerning the use of predispute arbitration clauses in each type of account is discussed more fully below.

TYPE OF ACCOUNT	# OF FIRMS WITH SUCH ACCOUNTS	# OF FIRMS WITH ACCOUNTS COVERED BY ARBITRATION CLAUSES	% OF ACCOUNTS COVERED BY ARBITRATION CLAUSES
MARGIN	54	48	96%
OPTIONS	54	45	95%
CASH	59	29	39%

A. Margin accounts

Predispute arbitration clauses are used most frequently with margin and options accounts. All of the large retail firms 4/ require predispute arbitration clauses when a customer opens a margin account. 5/ Fifty-seven percent of the other

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2/ See discussion below concerning the number of firms reporting account numbers. A summary of data received on the number of each type of account directly covered by a predispute arbitration clause is attached as Exhibit C.

3/ See page 6 for a discussion of the indirect coverage of accounts by predispute arbitration clauses contained in options and margin account agreements.

4/ The term "large retail broker-dealers" refers to the 25 NYSE member firms examined, with the exception of seven firms with primarily institutional clients. Some of these firms also use predispute arbitration clauses.

5/ Not all accounts at these firms are subject to predispute arbitration clauses. About five percent of the accounts were opened before the firms implemented their current policy of requiring the clauses. All future accounts would be covered by the arbitration clauses.

NYSE firms examined and ninety percent of the NASD firms examined that have retail margin accounts employ the clauses. 6/ Overall, 89% of the firms that have retail margin accounts use the clauses for their margin account customers.

Twenty of the 25 NYSE firms examined provided data showing the number and percentage of retail margin accounts covered by the arbitration clauses. All 29 of the 40 NASD firms examined that have retail margin accounts provided this information. The data received indicates that 96% of the margin accounts (out of a total of 3,907,166 margin accounts at the firms that provided specific data) at the NYSE firms that provided information in response to this portion of the examination 7/ and 95% of the margin accounts (out of a total of 349,308 margin accounts) at the NASD firms with retail margin accounts are covered by predispute arbitration clauses.

RETAIL MARGIN ACCOUNTS SUMMARY

FIRMS WITH RETAIL MARGIN ACCOUNTS	FIRMS WITH MARGIN ACCOUNTS INCLUDING ARBITRATION CLAUSES	% OF ACCOUNTS COVERED CURRENTLY BY CLAUSES
NYSE	NYSE	NYSE
25	22 (88%)	96%
NASD	NASD	NASD
29	26 (90%)	95%

6/ Three of the NYSE broker-dealers we examined had no predispute arbitration clauses in effect for their margin accounts. Since the staff's review one of those three firms has sold most of its retail accounts to NYSE members that use predispute arbitration agreements. The other two firms principally have institutional clients; further, one of these firms has stated that it is considering adding predispute arbitration clauses to its customer agreement forms.

The three (10%) non-NYSE member firms that do not use predispute arbitration clauses are relatively small and account for only 1000 retail customer accounts or .3% of the total accounts in our sample of accounts.

7/ All five of the NYSE firms that did not provide statistical data showing the number and percentage of accounts covered use predispute arbitration clauses for margin accounts.

B. Options accounts

Twenty-one of the 25 NYSE firms examined use arbitration clauses in their options account agreements. [8/] Twenty-four of the 29 NASD firms examined that have retail options accounts use the clauses in their customer agreements for options accounts.

Eighteen of the 25 NYSE firms reported the number of their options accounts that are covered by predispute arbitration clauses. Twenty-three of the twenty-nine NASD firms with retail options accounts provided the data. The firms' responses indicate that 95% of the options accounts at those NYSE firms that responded (out of a total of 1,319,578 options accounts), and 91% of those accounts at the NASD firms that responded (out of a total of 145,093 options accounts) are covered by predispute arbitration clauses. Furthermore, some percentage of the remaining accounts would be indirectly covered by arbitration clauses in the margin account documentation for options customers who have margin accounts. [9/]

OPTIONS ACCOUNTS SUMMARY

FIRMS WITH OPTIONS ACCOUNTS	FIRMS WITH OPTIONS ACCOUNTS INCLUDING ARBITRATION CLAUSES	% OF ACCOUNTS COVERED CURRENTLY BY CLAUSES
NYSE 25	NYSE 21 (84%)	NYSE 95%
NASD 29	NASD 24 (83%)	NASD 91%

C. Cash accounts

The staff's review also documented that many cash accounts at the nation's broker-dealers are covered explicitly by predispute

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[8/] Four of the NYSE firms or sixteen percent of the NYSE sample, stated that there were no arbitration clauses specifically covering their options accounts. However, two of these firms stated that they planned to add arbitration clauses soon. At least one of these two firms has now done so. As noted in footnote 4, the third of the four firms has sold most of its retail accounts to firms that use predispute arbitration clauses since the review. The fourth firm does not have a large retail customer base.

[9/] See discussion infra. p.6 at note 14.

arbitration clauses, but many others are not. About 39% of the cash accounts at the firms examined that reported specific account number data are covered directly by predispute arbitration clauses. About 40% of the firms reported that they do not require a customer agreement form for cash accounts as they do for margin and options accounts. Most firms that require the execution of customer agreements for cash accounts include a predispute arbitration clause in the agreement. Three NYSE firms and eight NASD firms have cash account agreement forms without arbitration clauses. 10/

1. NYSE firms

Firms that account for 46% of the cash accounts at the NYSE firms examined, and which provided data on the number of their accounts covered by the clauses, include predispute arbitration clauses in their customer agreement forms. 11/ However, only 38% of the cash accounts at NYSE firms (out of a total 10,392,612 cash accounts) are currently covered directly by predispute arbitration clauses. Some firms have added the clauses in recent years for new cash account customers, but have not amended the contracts for existing customers. As accounts are closed out at these firms, or new customer agreements are executed by existing customers for other business reasons, the percentage of cash accounts covered will increase. Prospectively, at these firms, it appears that all cash accounts will be subject to a predispute arbitration clause. 12/

10/ Two of the firms are large retail broker-dealers. Since the staff's review, one of those firms has sold most of its retail accounts to NYSE members that use predispute arbitration agreements.

11/ Some firms responded that they required arbitration clauses in cash accounts, but provided no statistical information.

12/ If all the accounts at firms which now require arbitration clauses in cash accounts become covered, the percentage of accounts would increase from 38% to 41%. The remaining 5% difference between the accounts at firms that currently use clauses for cash account agreements (46% of the accounts), and those accounts that are subject to such clauses (38%) is explained by the fact that three firms currently only request, but do not require, cash account customers to sign the agreement forms. These three firms do not negotiate with respect to the arbitration clauses; they simply do not have a policy requiring the execution of customer agreement forms for cash accounts. Two of these firms are large retail broker-dealers.

In addition, two firms, accounting for 5% of the NYSE cash accounts stated that they intended to add the clauses, and four firms, accounting for 37% of these accounts, represented that they were considering the use of predispute arbitration clauses for their cash accounts. No firms provided a timetable for their actions with respect to the clauses. 13/

The staff also understands from conversations with personnel at a number of firms that many customers at broker-dealers may have more than one type of account at the firm, i.e., persons with cash accounts at a firm also may have margin and/or options accounts at the same firm. Forty-four of the 49 firms that utilize predispute arbitration clauses include language in those clauses that covers all transactions and dealings between the parties. 14/ Thus, some cash accounts are covered indirectly by the arbitration clauses governing other accounts held by the customer at the firm. The staff could not determine based on the information provided in the examination how much this increases the total percentage of cash accounts covered by predispute arbitration clauses.

2. NASD firms

Firms accounting for 97% of all of the cash accounts (out of a total of 3,232,784) at the NASD member firms examined include predispute arbitration clauses in customer agreements for new cash account customers. Currently, only forty-one percent of cash accounts at the NASD firms are covered directly by predispute arbitration clauses because many customers opened accounts before these clauses were added to the forms. As the accounts at these firms turn over, or existing customers reexecute account agreements, the percentages will increase. Again, some additional percentage of accounts is covered indirectly through margin or options account agreements.

13/ The data used by the staff for its report was submitted by the firms between October and December 1987. In May 1988 the Securities Industry Association conducted a telephone survey of the eleven largest retail broker-dealers. The SIA reported that while some of those firms had considered the use of predispute arbitration clauses for cash accounts, they had since rejected the idea. See Written Statement of the Securities Industry Association before the Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce dated Thursday, June 9, 1988.

14/ See Exhibit B.

RETAIL CASH ACCOUNTS SUMMARY

FIRMS WITH CASH ACCOUNTS	FIRMS WITH CASH ACCOUNTS INCLUDING ARBITRATIONS CLAUSES	% OF ACCOUNTS COVERED CURRENTLY BY CLAUSES
NYSE 25	13 (52%) 15/	38%
NASD 34	16 (47%)	41%

Customer's Ability to Negotiate a Waiver

In its examination, the staff asked firms whether they would remove their arbitration clause at the request of a retail customer. Only four broker-dealers stated that they had written policies addressing the waiver of arbitration clauses. At these four firms the written policy provides that the firm generally will not permit the clause to be waived and will not accept the account without the arbitration provision. In addition, fifteen firms have unwritten policies or instructions to employees that prohibit waiving the clauses. Another eleven firms stated that requests to delete the arbitration provision would be resolved on a case by case basis by senior personnel.

In order to better understand firm policies in this area, the staff also asked firms to estimate how many accounts had actually had the arbitration provision waived. One firm responded that the arbitration provisions had been waived by mistake for about twenty-five accounts, but that it would not happen again assuming that the appropriate personnel are involved in reviewing such matters. Another firm thought that the provision had been waived for a few accounts. No other firm provided figures, and every firm noted that this data could only be retrieved by manually reviewing all customer account files.

15/ Three of these firms do not require the signing of a customer agreement in order to open a cash account. One other firm uses the agreements only for its IRA accounts. Accordingly, the column for accounts covered includes only IRA accounts for that firm.

Policy Changes in the Wake of Dean Witter Reynolds v. Byrd and Shearson/American Express v. McMahon

In its examination, the staff also asked firms whether they intended to change their practices in light of Byrd and McMahon and whether they include the American Arbitration Association ("AAA") as an arbitration forum choice.

Twenty of the 65 firms examined stated that they intended or were considering policy changes with respect to the use of arbitration clauses in order to expand the number of accounts covered by the clauses. The changes fall into two categories. Some firms plan to remove current perceived limitations in their existing clauses that could exclude federal securities law claims from the scope of the agreement in order to assure explicitly that these claims are covered by the clause. This change will be made in light of the ruling in McMahon which permits such extension. As noted previously, six firms, representing 42% of the NYSE retail cash accounts, reported that they plan or are considering whether to introduce arbitration clauses for cash accounts. 16/

Thirteen of the 65 firms (20%) examined stated that they include the AAA as a forum choice for disputes in their account agreements. Two firms stated that they would arbitrate at the AAA upon the request of the investor. Five firms are considering whether to add AAA to their clauses. Four firms stated that they had used AAA in the past but no longer do so; three of these firms explained that AAA was dropped because the firm had had unfavorable experience with AAA in the past. One firm stated that it had deleted AAA as one of the forum choices it provides in its arbitration clause because the Commission does not have oversight authority over the AAA as it does over the SROs. The Securities Industry Association includes the AAA as a forum in its sample arbitration clauses, but not many firms appear to have accepted AAA. Nevertheless, while AAA has not been a major securities arbitration forum, the AAA's securities caseload has been growing in recent years. 17/

16/ But see footnote 10, supra.

17/ AAA administered 119 securities cases in 1986, 187 in 1987 and as of April 30, 1988, 161 cases. In contrast for example, the NASD, which administers the largest SRO program, administered 1587 cases in 1986, 2800 in 1987 and 1054 as of March 31, 1988.

EXHIBIT A

October 5, 1987

Dear :

The Division of Market Regulation ("Division") is conducting an examination of the use of arbitration clauses in customer agreements currently used by broker-dealers registered with the Commission. Enclosed you will find a three page special examination outline ("Special Examination") requesting specific information relating to your firm's use of predispute arbitration contracts.

By collecting this information in writing, we hope to avoid the need for an on-site examination. Please send your responses to Sarah Ackerson, Assistant Director, of the Division's Office of Self-Regulation Inspections no later than the close of business on October 21, 1987. If you have any questions regarding this examination, you may telephone Robert Love at (202)272-3064 or Sarah Ackerson at (202)272-7471.

Thank you for your cooperation in this matter.

Sincerely,

/s/

Richard G. Ketchum
Director

Enclosure

SPECIAL EXAMINATION

Pursuant to Section 17 of the Securities Exchange Act of 1934 ("Act") [15 U.S.C. 78q], and Rules 17a-3 and 17a-4 under the Act [17 CFR 240.17a-3 and 240.17a-4], the Securities and Exchange Commission's Division of Market Regulation ("Division") requests your immediation attention to the following inquiries. The Division requests that your responses be received by the Office of Self-Regulation Inspections, of the Division no later than the close of business on October 21, 1987.

Send your response to: Sarah Ackerson, Assistant Director, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549, Mail Stop 5-1,

INSTRUCTIONS:

1. Please send a sample of each of the following firm documents currently being used;

   a. principle customer agreements for margin accounts;
   b. principle customer agreements for options accounts;
   c. principle customer agreements for cash accounts;
   d. any other standard customer agreements that are used in connection with more than 5% of the firm's accounts;
   e. any trade-related documents, such as a confirmation, that includes in the firm's view an agreement to arbitrate; and
   f. any other standard agreements that are used in connection with more than 5% of the firm's accounts and include arbitration provisions.

Please provide a written response to each question listed below.

2. What changes to arbitration clauses in standard agreements have been made, or does the firm intend to make, in response to the Supreme Court's decision in *Shearson/American Express v. McMahon*, 482 U.S.   (1987) or *Dean Witter v. Byrd*, 105 S.Ct. 1238 (1985).

3. Does the firm now include, or is it considering whether to include the American Arbitration Association as one of the arbitration forum choices in any arbitration agreement?

4. Please estimate the number and percentage of the firm's current customers that have entered into agreements with the firm that include arbitration clauses.

Total No. of Accounts	No. of Accounts Covered by Arbitration Clauses	Percentage of Accounts Covered by Arbitration Clauses
______	______	______

Include the basis for, or assumptions that you have made in making your estimate. If the firm's records permit distinctions among different types of accounts and account forms used (i.e., cash, margin or options), please also estimate a breakdown of the number and percentage of the firm's current customers who entered into agreements with an arbitration clause by the type of account form.

Cash Accounts

Total No. of Accounts	No. of Accounts Covered by Arbitration Clauses	Percentage of Accounts Covered by Arbitration Clauses
______	______	______

Margin Accounts

Total No. of Accounts	No. of Accounts Covered by Arbitration Clauses	Percentage of Accounts Covered by Arbitration Clauses
______	______	______

Options Accounts

Total No. of Accounts	No. of Accounts Covered by Arbitration Clauses	Percentage of Accounts Covered by Arbitration Clauses
______	______	______

Other (Specify)

Total No. of Accounts	No. of Accounts Covered by Arbitration Clauses	Percentage of Accounts Covered by Arbitration Clauses
______	______	______

5. In what circumstances is the firm willing to waive or negotiate its arbitration provision? Estimate how many accounts have actually had the arbitration provision waived.

   a. Please enclose a copy of any written guidelines used by the firm in determining whether to waive a predispute arbitration provision in a customer agreement. In addition, please describe any non-written policy on this issue.

   b. More specifically, what written or oral instructions are given to the firm's registered representatives for those situations where a customer crosses off the arbitration provision in standard contracts, or requests that the firm delete the clause, or questions whether signature on the form with the clause is mandatory?

   c. What written or oral instructions are given to the compliance personnel responsible for reviewing new account documentation for those situations in which the documentation includes a contract on which the arbitration provision has been crossed off?

   d. In light of McMahon, is the firm considering a change in its policy with respect to whether a customer must sign a predispute arbitration agreement in order to open an account with the firm?

EXHIBIT B

	CLAUSE IN MARGIN CONTRACTS	CLAUSE IN OPTIONS CONTRACTS	CLAUSE IN CASH CONTRACTS *,**,***	CLAUSE COVERS TRANSACTIONS IN ALL ACCOUNTS	AAA PROVIDED AS ALTERNATIVE FORUM ****
TOTAL FIRMS	49/65	46/65	28/65 * (3) ** (11) *** (6) NP (1)	44/49	13/49 **** (2)
NYSE FIRMS	22/25	21/25	12/25 * (3) ** (3) *** (6) NP (1)	19/25	7/22 **** (2)
NASD FIRMS	27/40 *****	25/40 *****	16/40 ** (8)	25/27	6/27

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* Denotes that signing of customer agreement is not required.
** Firm uses customer agreement for cash accounts without arbitration clause.
*** Considering use of clauses in cash accounts.
**** Not in clause, but will add at request of client.
***** Eleven of the NASD firms in the sample do not have margin or options accounts.
NP Not provided.

EXHIBIT C

SUMMARY OF USE OF PREDISPUTE ARBITRATION CLAUSES

TYPE OF ACCOUNT	# OF FIRMS REPORTING DATA	# OF ACCOUNTS	# OF ACCOUNTS COVERED BY ARBITRATION CLAUSES 1/	% OF ACCOUNTS COVERED BY ARBITRATION CLAUSES
MARGIN	49/54	4,256,474	4,068,514	96%
OPTIONS	41/54	1,464,671	1,390,567	95%
CASH	46/59	13,625,396	5,246,562	39%

1/ See page 6 of the report for a discussion of the indirect coverage of accounts by predispute arbitration clauses contained in options and margin account agreements.

Senator **Bryan**. Mr. Ketchum, we thank you very much for your testimony.

The chairman of the Budget Committee has taken time out from his busy schedule to join us this morning, and I invite Senator Sasser to make any statements or comments he would like to this morning.

Senator **Sasser**. Thank you very much, Senator Bryan. I have a statement which I would like very much to put in the record.

I want to commend you for being the driving force behind these hearings here this morning, and I look forward to hearing from the witnesses and perhaps having a question or two.

Thank you very much.

Senator **Bryan**. Thank you very much, Senator Sasser. Your statement will be made a part of the record.

We turn now to Ms. Bryant. Welcome, this morning.

STATEMENT OF SUSAN BRYANT, PRESIDENT, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, WASHINGTON, DC, ACCOMPANIED BY DON SAXON, FLORIDA DIVISION OF SECURITIES

Ms. **Bryant**. Good morning.

Thank you, Senator Bryan, and members of the subcommittee. I really appreciate the opportunity to be here today. I am here on behalf of the North American Securities Administrators Association, which, in the United States, is the national voice of the State securities regulators.

I'm also the administrator of the Oklahoma Department of Securities, and I've asked to accompany me today Mr. Don Saxon of the Florida Division of Securities.

I would appreciate it if when we get to the question and answer portion, that he could join me at the table.

Senator **Bryan**. That will be fine.

Ms. **Bryant**. In September 1989, NASAA released a study which indicated that consumers are robbed of an estimated $2 billion a year in penny stock schemes. With very few exceptions, the non-NASDAQ over the counter penny stock market no longer fulfills its traditional role as the cradle for America's new startup companies and expanding firms.

Instead, it has been flooded with insubstantial schemes dreamed up by profiteering brokerage firms and behind the scenes promoters who include in some cases chronic securities law violators and organized crime figures.

The penny stock schemes include purely fraudulent companies such as the ZZZ Best, which was created by Barry Minko, used to rob more than $60 million from investors. It also created a company called Gold For, which had developed what it called a secret process to turn the black sands of Costa Rica into gold.

The penny stock schemes also involve activities by brokers who specialize in manipulating the prices of these low-priced non-NASDAQ securities out of all reason, bilking innocent investors of billions of dollars that could otherwise have been used to finance legitimate businesses.

Such activities have devastated the legitimate capital-raising process in the United States. State, Federal and self-regulators have joined together to combat this process. We have had some limited success, as indicated by Mr. Goldstein; however, we need more tools to combat the problem.

We are here today to ask Congress' help in giving us the tools that we believe are needed to combat this very real problem. We would recommend that Congress prohibit registration and market-making activity in the blank check, blind pool securities that are used as a tool for developing these penny stock companies.

We would also ask that you require enhanced and meaningful disclosure to investors of the securities being touted and the persons selling them.

We would like to make it tougher for so-called Bad Boys to enter or continue in the business. We also recommend giving increased authority to the SEC, giving them cease and desist authority, authorizing the payment of bounties in the penny stock area and encourage continued and expanded use of criminal sanctions in this area.

We endorse the adoption of the two major pieces of legislation currently pending, including the Securities Law Enforcement Remedies Act and the International Securities Enforcement Cooperation Act. In addition, we believe Congress should strengthen the regulations aimed at fraudulent telemarketers.

Finally, the SEC should be provided with increased funding and manpower so that they can more adequately work to combat this very real problem.

To increase the confidence of investors in the market, we also recommend that you continue looking at the arbitration process to assure that it is voluntary, fair and open.

Mr. Chairman and members of the subcommittee, if reforms in the penny stock market are not adopted, we risk the very real chance of losing forever participation of the individual investor in our capital markets. The major deficiencies in the penny stock market which paved the way for fraud and manipulation must be corrected if we are truly committed to restoring the integrity of our capital markets, investor confidence in the markets and to give us the ability to compete in an international securities market.

Senator Bryan, we greatly appreciate the time and attention you have devoted to helping in the effort to clean-up the penny stock market nationally, as well as your involvement in the State of Nevada. We appreciate the activities of Frank del Pappo in Nevada, who has done a considerable amount.

We look forward to working with you and the members of the subcommittee to move forward to implement the types of reform we have endorsed, which are particularly included in your Small Investor Protection Act.

Thank you.

[The complete prepared statement of Susan E. Bryant follows:]

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

NASAA

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STATEMENT OF SUSAN E. BRYANT

PRESIDENT,
NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

before the

SUBCOMMITTEE ON SECURITIES
Committee on Banking, Housing and Urban Affairs
U.S. Senate

February 8, 1990

President: Susan E. Bryant (Oklahoma) • **President-Elect:** M. Douglas Mays (Kansas) • **Secretary:** Merrill H. Wiggnton (Prince Edward Island) **Treasurer:** Ellyn L. Brown (Maryland) • **Directors:** John C. Baldwin (Utah), Christine W. Bender (California), Stephen L. Diamond (Maine), John B. Hiatt (New Mexico) and Ralph A. Lambiase (Connecticut) • **Executive Director:** Lee Polson

Executive Summary

Investors lose an estimated $2 billion each year as a result of schemes involving penny stocks, according to a NASAA study released in September 1989, to the House Energy and Commerce Subcommittee on Telecommunications and Finance. Fraud and abuse in penny stocks undermines investor confidence in our capital markets and diverts investment funds which would otherwise go to legitimate businesses.

Many investors defrauded in the penny stock market find they must resolve their complaints through securities industry arbitration, rather than through the courts. Two recent Supreme Court decisions have upheld the enforceability of predispute arbitration agreements. While it is clear that there is a place and a very real need for an arbitration system, it must be perceived by the general public as fair and impartial, as well as efficient and effective.

NASAA respectfully submits to Congress a package of federal policy recommendations designed to correct the major deficiencies of the penny stock market -- the lack of information about the arcane workings of the marketplace and the flooding of the market by unscrupulous operators -- which make this market a prime target for fraud and manipulation. The policy recommendations also address arbitration reform.

Federal Policy Recommendations

1. Eliminate "blank check" blind pool offerings

   It is the very nature of the "blank check" blind pool -- an offering through which money is raised with no stated purpose for its use -- that has made it the leading vehicle in the penny stock market for fraud and abuse. No academic literature or anecdotal evidence suggests that these offerings make a net positive contribution to the U.S. economy. Congress should amend Sections 12 and 15 of the Securities Exchange Act of 1934 to prohibit registration under the Act and to prohibit market making activity in "blank check" blind pool offerings.

2. Require enhanced and more meaningful disclosure

   To counter the serious shortage of information in the penny stock market, Congress should:

   - Require a "Risk Disclosure" document;
   - Require basic disclosure about the investment;
   - Require broker-dealer and agent disclosure of disciplinary history prior to opening a customer account; and
   - Require a reworking of existing confirmation slips and customer account statements.

3. Prevent "bad boys" from entering or continuing in the business

The NASAA study of fraud and abuse in the penny stock market revealed overwhelming evidence that abusive penny stock brokerage operations are hiring, retaining and doing business with a large number of persons with extensive backgrounds of violations of federal and state securities law, felony convictions and ties to organized crime. To combat this problem, Congress should:

- Institute more effective sanctions against employment of "consultants" otherwise prohibited from the business; and
- Hike the time allowed for re-entry application.

4. Additional enforcement capability

Congress should:

- Grant the SEC cease and desist authority;
- Authorize the payment of bounties in penny stock cases; and
- Encourage criminal prosecutions.

5. Pending legislation

Congress should adopt:

- The Securities Law Enforcement Remedies Act;
- Key provisions of the International Securities Enforcement Cooperation Act;
- The Telemarketing Fraud Prevention Act; and
- Greater funding for the SEC.

Congress should reject:

- Efforts to weaken civil RICO, such as S. 438.

6. Arbitration

NASAA is strongly opposed to the practice that makes execution of a mandatory predispute arbitration agreement a condition of investing in the securities markets. The Association recommends that Congress:

- Consider expressly prohibiting mandatory predispute arbitration agreements; and encourage further reforms to the process.

Mr. Chairman and Members of the Subcommittee:

My name is Susan E. Bryant. I am Administrator of the Oklahoma Securities Department and President of the North American Securities Administrators Association (NASAA). In the United States, NASAA speaks for the grassroots government officials responsible for securities regulation and investor protection in the 50 states and the District of Columbia. With me today is Don Saxon, Director of the Securities Division of the Florida Office of the Comptroller. Mr. Chairman and Members of the Subcommittee, I appreciate the opportunity to appear before you today.

You have asked that NASAA testify today about penny stock fraud and how it has affected both small investors and the capital raising process. You also have asked that we speak to the arbitration process and its effect on small investors. This testimony is intended to answer your questions and provide information with respect to the issues you have raised. For purposes of this testimony, the term "small investor" refers to individuals with limited financial resources for investment in the securities markets.

THE PENNY STOCK PROBLEM

Abuse of penny stocks[1] is not new and dates back at least to the 1940s and 1950s when worthless shares of uranium mine stocks were bought and sold over the counter of a Salt Lake coffee shop. Until the last decade, penny stock fraud was largely considered a regional aberration, confined mostly to the penny stock centers of Denver, Utah and Spokane. However, during the 1980s, the number of brokerage firms specializing in penny stock trading has increased almost five-fold. Half a decade ago, 55 penny stock firms were headquartered in fewer than six states. As of mid-1989, an estimated 325 penny stock firms had set up main offices in 29 states, in addition to operating thousands of branch offices which now reach down into even the smallest communities of America.

The types of penny stock problems state securities regulators see take several different forms. First, there is the purely fraudulent company. In most instances, but not always, the company is taken public as a "blank check" blind pool company and then marketed as a public shell. No information is available concerning the promoters who receive large blocks of stock or the true purpose of the company. Once a public offering is completed, the shell is then merged with an existing corporation. The company therefore, is effectively "taken public" without compliance with securities registration requirements. The publicly held stock is then traded based on the touting of the merged company's activities by insiders who knowingly provide false information about the company's activities or prospects.

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[1] Roughly 13,000 over-the-counter (OTC) stocks, most ranging in price from one cent to three dollars and traded outside of the National Association of Securities Dealers Automated Quotation (NASDAQ) system, appear in the "pink sheets" published daily by the National Quotation Bureau. The pink sheets are home to the vast majority of penny stocks, as defined for the purposes of this testimony. It is acknowledged that there are stock traded in the pink sheets that are neither manipulated nor fraudulent. It is further acknowledged that there are brokers trading penny stocks who do not use unethical business practices. This discussion relates only to the growing ranks of problem penny stocks and brokers.

Second, there is fraud on the part of the selling agents. Rumors of significant revenues, exclusive rights to products, potential mergers, secret processes and other alleged insider information are used by the brokers to manipulate the price of the penny stock upward until the brokers and insiders have bailed out of all their stock at inflated prices. Such sales methods can be used where the stock of an otherwise legitimate company is pushed on the public increasing the price well beyond any reasonable value. Investors are sold on the idea of getting into the next Apple Computer.

The third type of problem relates to the sales practices of the broker making the market in their stocks irrespective of the underlying value of the company. Sales practice abuses of penny stocks cover a range of activities of which the most abusive is the high-pressure, boiler room techniques used to sell penny stocks to innocent investors. A second abuse consists of selling high risk penny stocks to persons for whom the investment is highly unsuitable. Other abuses involve brokers refusing to take sell orders for stocks, excessive mark-ups, where an investment is worth only half of what is paid for it, cross-trading among brokers to run up prices and failure to properly evaluate a company before selling its stocks.

The magnitude of the penny stock problem can be directly attributed to the enormous profits derived by insiders and promoters on the sale of their stock at grossly inflated prices and to the huge profits made by the brokers through large commissions and mark-ups.

The Information Gap

There are additional factors which contribute to the penny stock problem discussed above. The first relates to the disclosure of information. The philosophy of federal securities regulation is centered on disclosure of material facts. In theory, if full disclosure of material facts is mandated and achieved, investors are able to make their own informed decisions. The purest application of the full disclosure philosophy in secondary market trading is found in free, liquid markets where intense competition, instant access to information and thousands of independent analysts, brokerage firms, brokers, institutions and advisers all combine to approach the concept of an "efficient market."

Many penny stocks are registered at the federal level as "blank check" blind pool offerings. Although ostensibly complying with the registration requirements of the Securities Act of 1933, the information provided to investors simply states that it is "unknown what will be done with the proceeds" of the offering. Many state securities regulators refuse to register such offerings on the grounds that a failure to disclose how the offering proceeds will be used does meet the requirements of "full disclosure." Equally troubling are those "blank check" offerings registered solely as a means for yet another company to evade the registration requirements by merging with a blank check company which has completed the registration process. In these instances, companies are allowed to become publicly traded without initially providing adequate information to investors about the merged company.

There is a lack of adequate or accurate information in the secondary trading market as well. It has been our experience that, as discussed above, some penny stock companies are actually frauds on the public and false information is provided to the brokers by insiders and subsequently to the public. Any market maker of a security is required to conduct a due diligence review of a company before making a market in its stock. Such review is designed to ensure that the public is given accurate and adequate information concerning a security for which he is solicited by his broker. It has been our experience in the penny stock area that this due diligence review is often not done adequately, if at all. As a result, the brokers may have outdated or bad information with respect to the securities. Many brokers may rely simply on the pink sheet which are the sheets on which quotations are maintained to determine securities prices. The prices maintained on the pink sheets are not necessarily reflective of competitive prices or prices which may actually be paid for the securities.

In addition, it has been our experience that brokers in this area may try to mislead investors into believing a given company is about to do something extraordinary that will inflate the price of its securities. Such rumors are intended to manipulate the price of the stock upward until all of the stock can be dumped on the public. Again, there is a complete lack of accurate information disseminated to the public about the particular company.

Another problem we have seen is the absence of competitive pricing due to the lack of a number of independent market makers. In some of the securities we may see a single market maker who completely controls the price, or, in some instances several market makers, all of whom work in concert to manipulate the price. This results in a noncompetitive market and can be used to manipulate the price upward.

Penny stocks may be thinly traded and subject to domination and control by a single market maker. As such, unlisted securities are attractive vehicles for manipulative, artificial schemes which are intended to raise the price or trading volume of the securities, primarily for the benefit of the often unnamed insiders, and frequently, the brokerage firm itself which may unload its own shares of a stock into the market it has helped send skyward. The hallmarks of penny stock manipulation include: control by one or only a few brokers who often have contacts with the promoter or the issuer; matched purchases of sales of the penny stock to drive up prices, also known as cross-trading; excessive spreads between "bid" and "ask" prices; false and misleading rumor-mongering and hype to inflate the prospects for a stock; and the dumping of securities at inflated prices by the promoters or brokers who move on to the next manipulative scheme.

"Bad Boys" In The Business

Due to the enormous profits to be derived from the penny stock market, the market has become a haven for repeat offenders of state and federal securities laws and other felons, some of whom have been identified as having ties to organized crime and drug trafficking.

For a short time, one of the best-known securities firms in America was First Jersey Securities. Nationwide commercials during the Super Bowl, on the evening network news, and advertisements in major publications invited investors to "come grow with us." Before the firm suspended operations, it had grown to $85 million in assets, with 1,300 employees and 41 offices across the country.

What kind of people were involved in First Jersey Securities? The firm's "director of corporate projects" was convicted of securities violations and tax evasion and used an alias. Three other high ranking officials at the firm had been accused of securities violations, and had been enjoined, censured or suspended from the securities business at one time or another. In nine of the 39 companies whose stock First Jersey had underwritten, principal owners or officers -- or the companies themselves -- had been accused of securities violations; in two cases, company owners or officials had been convicted of criminal activity in connection with running those companies.[2]

Equally disturbing is the "cloning" of penny stock firms. High volume penny stock brokerage firms become training grounds for a new generation of promoters who then set up hundreds of copycat operations. Investors Center, Inc. (ICI), a penny stock firm headquartered in Hauppaguge, New York, closed its doors a year ago after an SEC investigation. One month later, the former ICI chairman was reportedly already at work helping ex-employees of the firm set up other penny stock brokerages.

Finally, the typical penny stockbroker now bears little or no resemblance to the trained professional in major brokerage firms who deals with investors. State and federal officials fear that part of the explanation for the surge in penny stock fraud and abuse is the predominance of the high-pressure telemarketing sales techniques previously associated with illicit "boiler room" promotion of bogus investments in oil and gas wells, "dirt pile" gold mine schemes and coins. There are numerous indications that individuals with little or no securities industry knowledge or experience are recruited by penny brokerages and then trained in classic "boiler room" pressure techniques. Penny stock salespeople may use detailed sales pitch scripts which are intended to overpower any objection through the use of intimidation and misleading, false and blatantly fraudulent claims and assurances.

Penny Stocks and the Small Investor

You have asked that we also testify today concerning the effect of the penny stock problems on the small investor. A NASAA study released at a September 7, 1989, hearing before the House Energy and Commerce Subcommittee on Telecommunications and Finance found that Americans lose an estimated **$2 billion** each year as a result of schemes involving penny stocks. The study also disclosed that small investor complaints of penny stock fraud and abuse climbed 51 percent from 1987 to 1988 and state securities agencies reported a two-year total of almost 4,500 penny stock-related consumer complaints, with 1,767 logged in 1987 and another 2,660 made in 1988.[3]

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[2] Matthew Purdy, "Brennan's Paper Empire, " The Philadelphia Inquirer, April 13-16, 1986.

The rapid changes in our capital markets over the last decade --the proliferation of new products and increased reports of scandals, including multi-million insider trading deals -- did not go unnoticed by the small investor. For most small investors, the vulnerability of our capital markets was fully realized with the events of October 19, 1987. It is obvious that since the market crash of more than two years ago, the small investor's approach to the markets has radically changed. In the state of Oklahoma, for example, we have seen a significant decrease in the number of registrations involving direct investment stock or partnership offerings, with a corresponding increase in the number of registrations involving investment opportunities offered through or primarily for institutions, such as mutual funds and unit investment trusts. From December 1986 to December 1989, registrations of direct investment stock or partnership offerings dropped 94 percent, from 52 to just three. At the same time, mutual fund registrations grew almost five-fold, from 31 to 145.

These numbers suggest that small investors -- who historically have provided most of the capital and support for companies at the beginning of their climb to success -- may no longer be willing to do so. Instead, small investors appear more comfortable investing their money through institutions rather than competing with those institutional investors and program traders in a market perceived to be volatile and unstable. Shying away from Wall Street, the small investor now appears more susceptible to the fraud and abuse of penny stock scams. Investors are given a false sense of hope in the penny stock market -- a market, they are told, that is designed for the small investor; a market where you do not have to compete with the billions of dollars institutions have to trade by computer; a market where all you need is a few thousand dollars to make the same kind of profits the institutions make on Wall Street. The estimated $2 billion lost each year as a result of penny stock fraud is money not invested in legitimate enterprises. It is money lost forever. Further, investors once burned generally do not return to the market. Instead, if they invest at all, these small investors will purchase mutual funds, unit investment trusts or bank certificates of deposit. The long-range implication of this dual problem -- the public perception that the capital markets may be too unstable for the small investor and the increasing vulnerability of small investors to penny stock fraud -- is that our economy may well be in danger of losing critical sources of funding for the small, start-up companies which are essential to continued economic growth.

The Capital Formation Process and the Impact of Penny Stock Fraud

It is clear that penny stock fraud has caused serious problems for legitimate capital formation. Legitimate small companies seeking to raise capital in the public markets are finding it increasingly difficult. Small, start-up companies have always represented a high-risk investment, but manipulations in the penny stock market of these securities have caused investors to lose money even in those cases where the underlying company is legitimate and may have been successful -- it only it had been given a chance. Manipulation of the stock will ensure that the company is never given a chance to prove its ability to succeed.

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[3] See, The NASAA Report On Fraud and Abuse In The Penny Stock Industry, September 1989.

Some penny stock brokerage firm officials seek to defend their products and marketplace from criticism by cloaking "venture stocks" -- perhaps the industry's most widely used euphemism for penny stocks -- in the mantle of free enterprise and entrepreneurship. George Hebert, secretary of Castle Securities has stated:

> It is obvious that unless the U.S. is stimulated in terms of capital formation and enterprise that the free-wheeling society peculiar to our nation will grind to a halt ... If our nation is not to join the Hittite, Etruscan and other greats that disappeared from history, it has to continue growing. It can only grow if risk entrepreneurship is permitted to prosper.[4]

Hebert goes on to point out that 75 percent of all new jobs in the U.S. are generated by new firms. It is in this context, he claims, that penny stocks are "a prime source for venture capital financing of all manner of innovations, inventions, new products and ideas." Other defenders of the industry are quick to point out that many current large firms once were to be found in the OTC market.[5] However, it seems apparent that these arguments ignore recent history, in particular, the growing domination since 1983 of fraud and abuse in non-NASDAQ secondary market trading of penny stocks. We would point out that, in order for investment capital to foster the growth of small companies, the funds raised from investors must actually go to those companies, not to the pockets of fraudulent penny stock operators.

If penny stock scams could be eliminated, the $2 billion NASAA estimated is lost annually in that market would be available for investment in the creation and expansion of new legitimate businesses. The loss due to fraud and abuse in penny stocks is equivalent to two-thirds of the estimated $3 billion invested in 1989 by venture capitalists.[6] Operating on the assumption[7] that an average of $25,000 in outside capital is needed to launch the typical small business, the $2 billion lost each year to penny stock swindles alone could launch 80,000 new firms, which in turn, would create more than 150,000 jobs for Americans.

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[4] Much of the discussion of the relationship between penny stocks and legitimate small business capital formation is taken directly from Chapter VIII, "The Economic Impact of Penny Stocks," pages 64-71, of the NASAA Report on Fraud and Abuse In The Penny Stock Industry, submitted September 9, 1989, to the House Energy and Commerce Subcommittee on Telecommunications and Finance.

[5] Boosters of non-NASDAQ OTC securities have a tendency to take credit for companies that spent their early days in NASDAQ and the exchanges. It should be pointed out that the track record of these more substantial companies casts little light on non-NASDAQ OTC securities.

[6] See: National Venture Capital Association, letter to Jonathan G. Katz, SEC, May 19, 1989, page 1; Jonathan B. Levine, "In Venture Capital, Few Are Flying Solo Anymore," Business Week, "Innovation 1989" issue, January 1989, page 164; Shelly Liles, "Venture

There are increasing reports of legitimate small business operators desperate for cash who are recruited as candidates for penny stock offerings. Often unsophisticated about the workings of the markets, the owners of these small firms sometimes end up paying exorbitant underwriting fees and giving up a large percentage of their company in cheap stock, options and warrants demanded by penny stock promoters, who often give little or nothing in return. Even an honest issuer may find that the taint of the manipulative scheme may foreclose the public capital market to that legitimate business for years or forever.

A recent example[8] of such a manipulation of a small business owner is reported to have proceeded as follows:

- An Oregon-based company was approached by penny stock promoters from Colorado who had a sham "shell" corporation that recently had completed a $500,000 public offering of stock.
- The penny stock promoters offered to merge the "shell" with the Oregon-based company, which was in dire need of operating capital. When the merger was completed, only $350,000 of the invested funds of the "shell" were made available to the Oregon company, while 30 percent of the stock offering proceeds were retained by the promoters. Without investing any of their own money, the penny stock promoters acquired 20 percent ownership of the Oregon company, roughly equal to the portion controlled by the public investors who had provided half a million dollars in capital to the "shell."
- In need of more cash, the company sought out capital from local financial institutions, "but found doors closed in its face when investment bankers learned of the company's involvement with penny stocks."[9]
- The price of the company's stock was manipulated by the Colorado penny stock promoters and more than doubled in the course of a year and a half, despite a steady decline in the financial condition of the Oregon company.

Capitalists' Investments Fall," USA Today, page 6B.

[7] See MIT professor David L. Birch quoted in "Hidden Economy," Wall Street Journal, June 10, 1988.

[8] For fuller details on this case, see Curt B. Gleaves, chair, Oregon State Bar Securities Regulation Section. statement, House Telecommunications and Finance Subcommittee, field hearing, Portland, Oregon, August 21, 1989, pps. 5-6.

[9] Ibid., page 5.

The promoters were suspected of artificially running up the price of the stock, selling their shares at the peak, allowing the market for the stock to fall, snapping up the newly-devalued shares,and then enriching themselves all over again by repeating the manipulative exercise.

- Locked out of alternate means of financing its cash needs, the Oregon firm continued to flounder and eventually failed.

State securities regulators find they must balance the risks of registering problem penny stock companies with the need to encourage legitimate capital formation. Complying with the registration provisions of state securities laws may result in some additional costs to legitimate companies seeking access to the public markets. In order to alleviate any unnecessary burdens that may be imposed on legitimate small businesses, state securities regulators are exploring ways in which the registration process may be further streamlined for certain legitimate issuers.

Arbitration and the Small Investor

You also have asked that NASAA provide testimony concerning the remedies available to small investors seeking restitution. You have asked NASAA to assess the current arbitration process, including the ability of the arbitration system to handle the growing number of claims by customers and disputes among firms. As you know, NASAA's assessment of the arbitration system derives primarily from the complaints and comments state securities agencies receive from investors and from the work of the Association's Arbitration Committee. The discussion below, therefore, addresses those issues and questions with which NASAA has direct knowledge.

The number of securities arbitration claims filed in the last decade has significantly increased.[10] It is clear that there is a place and a very real need for an arbitration system. Arbitration can be an effective and cost efficient way to resolve many customer-broker disputes, particularly those involving small amounts of money, or in disputes where the only issues to be resolved center on whose version of the facts is accurate. In many instances, state securities regulators suggest to investors that they seek to resolve disputes with their brokers though arbitration. For the arbitration process to be successful, however, it must adequately balance the need to be efficient and cost effective with the need to be fair, impartial and open to public scrutiny.

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[10] Published reports indicate that an estimated 6,100 investors filed securities arbitration claims in 1988, up from the 830 investors who sought such relief in 1980.

In June 1988 testimony before the House Energy and Commerce Subcommittee on Telecommunications and Finance[11], NASAA called on Congress, the Securities and Exchange Commission (SEC) and the securities industry to design an arbitration system that balances the legitimate business concerns of securities industry professionals with the needs and rights of investors. Since that time, many reforms and changes to the arbitration process have been made. NASAA commends the SEC for its review of arbitration procedures and efforts to reform the system. Likewise, we applaud the Securities Industry Conference on Arbitration (SICA) and its individual self-regulatory organization members[12] for implementing some of the procedural reforms suggested by the Congress, NASAA, the SEC and consumer representatives. These reforms undoubtedly have improved the arbitration system. For example, the number of complaints received by the Oklahoma Department of Securities concerning the arbitration system have dropped. However, NASAA continues to have concerns and encourages further examination of the arbitration process to assure its effectiveness.

First, it is NASAA's position that arbitration should be a voluntary process. The Association strongly opposes the practice that makes execution of a mandatory predispute arbitration agreement a condition of investing in the securities markets. This opposition is more firmly held in the wake of the Supreme Court's decisions in Shearson/American Express, Inc. v. McMahon and Rodriguez de Quijas v. Shearson/American Express, Inc. These two cases upheld the enforceability of mandatory arbitration of customer-broker disputes where a predispute arbitration agreement had been executed. The result is that securities law issues are now increasingly resolved in an arbitration forum where arbitrators are not required to follow the law, nor are they required to publish an opinion indicating the basis for their decision. Mandatory predispute arbitration agreements in this context take away an investor's right to be heard in court on issues that are often complex and difficult to resolve.

A second issue relates to the choice of forum for arbitration. Many securities industry arbitration agreements stipulate the forum in which a dispute may be arbitrated. At present, the National Association of Securities Dealers (NASD), the various stock exchanges and the American Arbitration Association provide arbitration services. Restrictions on where a customer may go to arbitrate a dispute not only limits that customer's choice of forum, it also appears that under the current system, the burden of operating the arbitration program has fallen disproportionately to the NASD.[13] Recently, the Securities Industry Association (SIA) called for the establishment of a single industry-wide agency to handle arbitration of customer disputes. If this proposal is endorsed, the issue of choice of forum may no longer be relevant. NASAA recommends that before a single industry-wide agency is established, a study be made to provide policymakers answers to the following pertinent issues:

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[11] See statement of James C. Meyer, president, North American Securities Administrators Association, before the House Energy and Commerce Subcommittee on Telecommunications and Finance, June 9, 1988.

[12] Members of SICA include the American, Boston, Cincinnati, Midwest, New York, Pacific and Philadelphia stock exchanges; National Association of Securities Dealers; Chicago Board Options Exchange; Securities Industry Association; Municipal Securities Rulemaking Board; and four public members.

- How would investors be advantaged by a single industry-wide arbitration system? How would the securities industry be advantaged? What are the disadvantages to both investors and the industry?
- Should a single agency be wholly independent and separate from the securities industry? If so, how would the agency be managed? Who would set the rules? Would the SEC continue to play an oversight role?
- How would a single arbitration agency, whether or not independent, be funded? SIA president Edward O'Brien has reported that the industry spends $12-15 million per year on arbitration overhead costs. Would each self-regulatory organization continue to pay for the costs involved in maintaining an arbitration system?
- What additional changes to the arbitration process should be adopted to restore investor confidence in the system?

NASAA is also concerned by a recent ruling by the United States District Court for the District of Massachusetts which held that regulations to prohibit mandatory arbitration agreements promulgated by the Massachusetts Secretary of State conflicted with the Federal Arbitration Act's "liberal federal policy favoring arbitration agreements." The decision is now on appeal to the U.S. Supreme Court. The Massachusetts appeal to the Supreme Court is supported by 30 state attorneys general who stated that the Federal Appeals Court ruling leaves them "powerless to protect consumers from being coerced to enter arbitration agreements." It is the position of NASAA that the states have a legitimate interest in regulating the conduct of persons licensed to do business within their respective jurisdictions and that a federal law or interpretation thereof to the contrary warrants further examination.[14]

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[13] It has been reported that nearly 4,000 of the 6,100 arbitration cases filed in 1988 were done so with the NASD. Approximately 1,600 cases were filed with the New York Stock Exchange (NYSE) during this same time.

[14] In October 1988, the NASAA membership adopted a "Resolution Concerning the Execution of Compulsory PreDispute Arbitration Agreements as a Condition Precedent to Obtaining Brokerage Services," in which NASAA expressed "support [for] the goals and policies of the Massachusetts rules as being consistent with NASAA's purpose of advancing the principle of investor protection and affording choice to investors in their decisions to participate in the securities markets."

Federal and State Securities Regulation

The dual jurisdiction of securities regulation in the United States provides comprehensive regulation of the capital markets and permits a highly efficient division of labor between the individual states and the Securities and Exchange Commission (SEC). The historical focus of state securities regulation has been investor protection while the federal focus has been on regulation of the markets. This division became more pronounced during the 1980s when the SEC focused much of its attention on prosecuting illegal, insider trading. The SEC, through the provisions of the Securities Exchange Act of 1934 (1934 Act) and through its oversight of the entire securities market, was uniquely equipped to handle these insider trading cases.

At the same time, state securities regulators started to receive increased numbers of complaints from individual investors indicating some major problems affecting their investment in the markets. Many of those investor complaints involved investments in the penny stock market and are the subject of the September 1989 NASAA Report on Fraud and Abuse in the Penny Stock Industry. The findings of that study are discussed above.

Calling penny stock fraud "one of the most menacing problems facing investors, regulators and the legitimate industry," then-SEC Chairman David S. Ruder announced in October 1988 the formation a Penny Stock Force to coordinate the Commission's efforts to seek efficient and effective solutions to the penny stock problems. The Penny Stock Task Force has undertaken efforts to increase investor awareness of how to recognize and avoid fraudulent penny stock schemes. At least two investor bulletins on penny stock fraud have been produced and are now distributed to persons who contact the Commission or the agency's regional offices. An important outgrowth of the Task Force has been the strengthened cooperation and collaboration among federal and state regulators, prosecutors and the NASD. The Task Force has sponsored nine regional meetings for the purpose of sharing information and discussing strategies for dealing with penny stock fraud. As a result of the Task Force's efforts, the SEC, NASAA and the NASD have worked together to attack the growing penny stock problem. Through enhanced communication and cooperation, regulators were able to determine which agency could best handle a given problem and cases were allotted accordingly.

States are working together and with the SEC and the NASD on joint examinations of problem penny stock firms. Cooperative enforcement projects have also been undertaken in order to more effectively ration the small pool of state, federal and industry regulatory staffpower. Eight states participated last year in the joint examination of a Denver-based penny stock firm, including the simultaneous entry of the firm's eight branches around the nation. The Oklahoma Department of Securities, the SEC and the NASD collaborated in 1987 and 1988 on actions taken against a Tulsa-based brokerage firm which engaged in manipulating the market valuation of a bogus gold mining stock from $2 million to $315 million.

This dual jurisdiction of state and federal securities regulation permits the strengths of each level to combine to form a comprehensive system for regulation of the capital markets. For example, many state regulators have the authority to criminally prosecute or work directly with a state attorney general to ensure that a case is handled expeditiously. Because the SEC does not have criminal prosecution authority, criminal cases are often referred to state securities regulators for prosecution. In a second area, the states, with a focus on investor protection, tend to adopt more effective regulations. As a result, more than two out of three states prohibit or substantially restrict the registration of "blank check" blind pool offerings.

Third, a total of 36 states use substantive (so-called "merit") standards to screen out securities offerings that may have provisions abusive or fraudulent to investors. Many states have used this authority to deny registration to companies that could be used for penny stock manipulations. In yet another example of state-federal cooperation, there have been instances where federal regulators with concerns about a particular securities offering have communicated those concerns to the state regulators reviewing the offering. The federal regulators communicate the concern knowing that those states regulators may applicable substantive standards to condition the offering or deny registration in cases where such action is warranted.

A number of states have launched additional initiatives in the fight against investment fraud and abuses, particularly to combat penny stock fraud and abuse. For example, some state legislatures have expanded the staff and budgets of their state securities agencies. Sizeable increases in positions and funding have been approved in the last five years in Florida, New Jersey, Nevada, New Hampshire, Utah and Oklahoma. A number of other states expect to make similar budgetary requests during the current and next legislative sessions. Still other states have developed innovative and aggressive programs to detect investment swindlers and to prevent them from operating in their states. Some states have used their extensive authority to screen out firms and salespersons with records of violations of securities laws and regulations. Other states are moving in the direction of increased criminal prosecution of penny stock swindlers and tougher application of civil and administrative penalties.

State securities agencies, both individually and collectively through the auspices of NASAA, are stepping up consumer education and other consumer outreach efforts. At least three states now have in place toll-free numbers for consumers to call if they have questions, need information or want to file a complaint. Established in March 1986, Florida's toll-free "Hotline" handled over 30,000 calls in just two years. The Hotline averages about 70 to 75 inquiries per day concerning registration of brokerage firms or individual stockbrokers, legal actions taken by the Comptroller's Office and general questions about investment instruments. In addition to providing a valuable service to investors, information compiled through Hotline calls permits staff to identify trends, problem firms and victims for investigative purposes. Through a computerized Complaint Tracking system housed in the Securities Division, the state recovered about $1.5 million for investors over a two-year span. Widespread distribution of brochures, "Investor Bulletins," and other educational materials is also a major component of the state consumer outreach effort.

Federal laws, however, provide remedies that may not be available under all state laws. For example, the 1934 Act has provisions concerning books and records and broker-dealer activities that are not necessarily included under the provisions of all state laws. Federal law also prohibits explicitly insider trading and market manipulation while most state laws do not. The passage of the Insider Trading and Securities Fraud Enforcement Act of 1988 was a significant step to prohibit the type of fraud that had been perpetrated on the market as a whole through insider trading and certainly complements the available criminal sanctions under state laws.

Finally, the SEC has the ability to regulate the brokerage community as a whole by adopting regulations under the 1934 Act which are applicable industry-wide. The SEC on August 16, 1989 adopted a rule (Rule 15c2-6) imposing new requirements on the sales practices of penny stock brokerage firms. Under the new "cold call" rules, brokers selling certain penny stocks will have to obtain a written sales agreement from any purchaser who is not a regular customer. Brokers also will have to obtain information about a purchaser's investment experience and financial condition. This new rule should be effective in reducing, if not eliminating, the high-pressure sales tactics used by abusive penny stock promoters, by addressing both the high-pressure telemarketing techniques and the targeting of clearly unsophisticated and unsuitable investors for these high-risk investments. The effect of the rules is that brokers will no longer be able to make a legally-binding sale of these securities over the phone due to a built-in "cooling off" period for customers to reconsider their decisions. The rules also should prove to be an important new enforcement tool, since penny stock firms now will be required to maintain a much more extensive record of their dealings with clients. Due to the limitations on the application of the rule, it should not prevent undue problems for legitimate broker-dealers.

Federal Policy Recommendations

Mr. Chairman and Members of the Subcommittee, since the October 1987 market crash, we have heard a great deal about restoring investor confidence in the integrity of our capital markets and bringing individual investors back into the markets. Two years ago, Congress moved a step closer toward that goal when it approved the Insider Trading and Securities Fraud Enforcement Act of 1988[15]. NASAA respectfully submits that fraud and abuse in the penny stock market may, in fact, prove more damaging to our capital markets than the insider trading scandals because it has directly affected the pocketbooks and lives of hundreds of thousands of unsophisticated investors, many of whom appear to be first-time entrants to the market and clearly unsuitable candidates for risky penny stocks.

The damage to investor confidence in our legitimate capital markets inflicted by widespread fraud and manipulation in the penny stock market was well articulated by Securities Industry Association (SIA) president Edward O'Brien:

> (The) SIA commends the Commission for its efforts to give priority to regulatory and enforcement initiatives aimed at preventing fraud and manipulation in the pink sheet market.

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[15] Pub. L. No. 100-704, 102 Stat. 4677.

> SIA shares the Commission's concern that the high pressure boiler room techniques employed by certain unscrupulous broker-dealers not only cause substantial harm to the investing public but also discredit the securities industry as a whole.[16]

Echoing these investor confidence concerns, John F. Guion, president of the National Association of OTC Companies (NAOTC), said,

> We completely support your desire to eliminate fraudulent and abusive sales practices in highly speculative securities. Since these activities usually involve high pressure and indiscriminate telephone recommendations largely to unknown persons who have little or no way to evaluate the merits of the security, these practices by their nature reflect poorly on the markets in general and greatly undermine investor confidence.[17]

The evidence is incontrovertible: Penny stock fraud and abuse has evolved into a problem of truly national proportions. ***NASAA respectfully submits for Congressional consideration a package of federal policy recommendations designed to correct the major deficiencies of the penny stock market*** -- the lack of information about the arcane workings of the marketplace and the flooding of the market by unscrupulous operators -- which make this market a prime target for fraud and manipulation.

Eliminate "blank check" blind pool offerings

An astonishing 70 percent of penny stock new issues floated in 1988 and 1989 were been blind pools, virtually all of them "blank check" offerings. These offerings are just what they sound like: Money raised with no definite purpose for its use. Promoters typically raise $50,000 to $200,000 by selling millions of penny shares in a new company that generally has no assets, no employees and no stated business plan. Frequently, "blank check" blind pools are merely "sham corporations" that are brought to market as vehicles for future manipulative conduct, which is widespread. The Colorado securities commissioner prefers to call these offerings **"deaf pools"**, as in: "give me your money and you'll never hear from me again."

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[16] Edward I. O'Brien, president, Securities Industry Association, letter to Jonathan G. Katz, secretary, SEC, regarding File No. S7-3-89, May 17, 1989. (The SIA is the trade association representing 575 securities firms headquartered throughout the United States and Canada.)

[17] John F. Guion, president, National Association of OTC Companies, to Jonathan G. Katz, secretary, Securities and Exchange Commission, regarding File No. S7-3-89, May 17, 1989. (The NAOTC represents the 840 companies whose shares trade in the over-the-counter market.)

State and federal enforcement actions indicate that "blank check" blind pools are used as vehicles for the illegal enrichment of individuals whose identities remain hidden. The desire for a low profile by the behind-the-scenes individuals in "blank check" deals frequently is a result of the fact that they are repeat securities law violators, many of them whom are under lifetime bars from the industry. Several other "blank check" blind pool penny stock promoters have been identified as convicted felons, some with ties to organized crime. One estimate has it that one out of every 10 penny stock blind pools registered by the SEC between 1985 and mid-1988 were linked to two long-time securities swindlers with known connections to the Genovese crime family and other underworld elements.

No academic literature or anecdotal evidence suggests that any net economic benefit results from the existence of "blank check" blind pools. In fact, it appears that the dollars raised in these offerings are matched several times over by the volume of resulting market manipulation, which, in short, means that the cost of "blank check" blind pools to society far outweighs any as yet unestablished benefit they bring about. "Blank check" boosters claim that blind pools help young companies get off the ground, but one Utah study of 350 blind pools found that only two survived as long as two years.[18] No published academic literature has been discovered that makes the case that "blank check" blind pool offerings are net contributors to the U.S. economy.

Perhaps one of the most notorious "blank check" blind pool frauds was carried out by Barry Minkow, the former chairman and chief executive officer of ZZZZ Best. Minkow was indicted on January 15, 1988, by a California grand jury for his promotion of ZZZZ Best, a rug and drapery cleaning business that at its height was claimed to be raking in $50 million in profits. As a result, ZZZZ Best stock soared from the penny range to as high as $18 a share. Minkow's firm eventually was exposed as an elaborate hoax, but not before he was lionized on the "Oprah Winfrey Show" and in much of the financial press as a teenaged entrepreneur who epitomized the "can do" spirit of America.

Two years later, the "boy genius" was convicted of securities fraud and sentenced to federal prison for masterminding the estimated $70 million penny stock fraud scheme. Essential to Minkow's rise to fame was the means by which he capitalized ZZZZ Best, which went public in just three months in early 1986 through a merger with a Utah "blank check" blind pool. Minkow's assessment of going public through the "blank check" blind pool route: "It was quick, clean and easy."

In the final analysis, it appears that it is the very nature of the "blank check" blind pool that has made it the leading vehicle in the penny stock market for fraud and abuse. Therefore, ***NASAA recommends that Congress amend Sections 12 and 15 of the Securities Exchange Act***

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[18] The study accounted for the merger activity of the 350 "blank checks" in making its determination that all but 18 had disappeared. See Mary Kuntz, "Janeway's Name Put on the Line," Newsday, June 11, 1989, section one, page 71.

of 1934 to prohibit registration under the Act and to prohibit market making activity in "blank check" blind pool securities.[19]

While many commentators have agreed that "blank check" blind pool offerings do not meet the full disclosure requirements of the federal securities laws and therefore should not be granted registration, the SEC has been forced to fight the manipulative "blank check" blind pools at the enforcement level -- after the money has been turned over from investors to the promoters. States, on the other hand, have moved to attack the underlying issue of registration. A total of 36 states have outright prohibitions or substantial restrictions on the registration of "blank check" blind pools.[20]

The State of Utah has moved to clean up its soiled reputation as the home of "blank check" blind pools. In 1986, Utah put new regulations in place which require that 80 percent of the offering proceeds of a "blank check" blind pool be placed in an escrow account until the promoter declares the business for which the proceeds will be used. At that time, given full disclosure about the intended use of the proceeds, shareholders are allowed to back out of the investment. In addition, the rule requires that promoters or inside shareholders provide an investment in the company equal to the lesser of 10 percent of the aggregate offering or $50,000, and sales agents must be bonded in the amount of $25,000. The result: In fiscal 1983, 217 blind pools registered with the Utah Securities Division raised $19.8 million. Under the new regulations, that number fell to 119 in 1986, 17 in 1987, and only five in 1988, raising just $500,000.

An April 29, 1989, resolution of the NASAA membership declares "blank check" blind pool offerings to be fraudulent per se and calls for their elimination. In explaining why these offerings should be eliminated, NASAA members said,

> . . . "blank check" blind pool offerings are inherently defective because of a failure to disclose material facts concerning the offering and issuer, and such offerings have been the subject of pervasive, recurrent abusive and fraudulent practices in the sale of securities, including but not limited to manipulation of the price of such securities, sales of securities at prices not reasonably related to the fair market value of such securities,

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[19] This recommendation is not intended to encompass investments in limited partnerships or other direct participation programs (also sometimes called "blind pools") where a detailed plan of business is developed, but the investment properties are unspecified (e.g., a real estate partnership to invest in apartment buildings which have not yet been selected).

[20] The 36 states are: Alaska, Arizona, Arkansas, California, Idaho, Indiana, Iowa, Kansas, Kentucky, Maine, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington and Wyoming.

> and fraudulent representations concerning the business plans and purposes of the issuers. . . . the Association finds that sales of "blank check" blind pool securities contain inadequate disclosure of facts about the issuer and the offering, tend to work a fraud on the purchasers thereof and cannot be justified for any useful economic purpose.

It is the rise of the "blank check" phenomenon that has shifted the emphasis of penny stock manipulation from the primary market of initial public offerings (IPOs) to the secondary market, which is the public trading of a stock that takes place after an initial public offering. There is widespread evidence that the greater emphasis on manipulation of secondary market trading is a key to the recent national surge in penny stock fraud. Under the multiplier effect of secondary trading, a $1 million new issue of a penny stock easily can account for $10 million or more of secondary market trading during the course of a manipulation scheme.

We can think of no rational reason why "blank check" blind pool offerings, which contain no meaningful information about how the company plans to spend the proceeds raised from investors, should be granted registration under the full disclosure requirements of the federal securities laws. In fact, it is clear that "blank checks" are the vehicles widely used by private companies to go public, through a "reverse merger" or "reverse acquisition," yet escape the regulatory scrutiny to which it would be subjected in an underwriting.

Enhanced and More Meaningful Disclosure

To counter the serious shortage of information in the penny stock market -- a problem which encourages widespread fraud and manipulation -- ***NASAA recommends that Congress endorse a new four-part marketplace disclosure program*** which will provide enhanced and more meaningful disclosure to investors about the stocks being offered for purchase and the persons promoting those stocks.

1. Require a "Risk Disclosure" document for all customers in penny stock transactions

Congress should amend the disclosure requirements of the Securities Exchange Act of 1934 to require that all customers who engage in non-NASDAQ penny stock transactions be provided with a newly-created "Risk Disclosure" document. SEC rulemaking to implement this new mandate should require that the "Risk Disclosure" document be written in plain English, and include, but not necessarily be limited to, the following pertinent discussions:

- An explanation that investment in penny stocks entails a high level of risk and that such investment should not be undertaken by any investor who is unprepared to accept the possible loss of all invested capital;

- A description of the risk factors unique to penny stocks in both initial public offerings and secondary trading;

- An explanation that when there are not at least three independent market makers for a stock, no reliable market exists; and
- A brief, clear description of the "bid" and "ask" method of market maker quotes for penny stocks and an explanation that price information on the penny stock may be available only through the brokers who are market makers in the stock.

If disclosure concerning the investment and the broker-dealer and agent's disciplinary history, as discussed below, is also required, the mandated "Risk Disclosure" document should prominently include references which would alert customers that they are entitled to this additional information. Customers who trade in penny stocks should acknowledge, in writing, that they have received and understand the "Risk Disclosure" document.

A fundamental abuse that appears deeply rooted in the penny stock market (and, most likely, is crucial to its existence) is the placement of unsuitable investors in the risky, volatile securities, including low-income elderly individuals whose primary source of income is Social Security benefits and those who are seeking low-risk investments with strong income potential. Documented cases of abuse include those in which penny stockbrokers have convinced clients to place penny stocks in their IRA accounts. It may be said that the suitability test applied by abusive penny stock firms is, quite simply, the ability to pay.

A mandatory risk disclosure document which would alert consumers to the high risk nature of penny stocks, despite misrepresentations or assurances of profit offered by penny stockbrokers, may save some investors from placing their money in these high risk ventures. How many people do you think know that there is an estimated 70 percent probability that an investor in an unmanipulated penny stock will lose some or all of his or her investment? We suspect not many.

A mandatory risk disclosure document, tailored to a particularly high risk class of investment, is not a radical concept. A written disclosure document, Understanding the Risks and Uses of Listed Options, is required reading for all investors who establish accounts for options trading, to ensure that investors in these high risk accounts have fundamental information regarding the nature of the options market and the particular risks inherent in it. Penny stock investments have proven to be at least as risky as investments in options. Investors in the penny stock market deserve, at a minimum, the same measure of protection that investors in options enjoy.

2. Require disclosure of basic information about the investment

Congress should direct the SEC to exercise current rulemaking authority to require that non-NASDAQ market makers provide a customer basic information about the investment. The disclosure should be made prior to the settlement of a penny stock trade and at no cost to the customer. That disclosure should include, but not necessarily be limited to:

- Recent financial statements for the company which issues the stock;

- A discussion of the most significant risks associated with an investment in the company; and
- A description of any affiliations between the company and the selling broker-dealer or sales representative.

It is well-documented that penny stock investors have few places to turn when attempting to learn basic information about the securities they may be pressured to purchase. This problem is particularly acute in the secondary trading marketplace. A requirement that the market maker provide a customer this information prior to settlement will greatly assist potential investors in making more informed investment decisions.

3. Require broker-dealer and agent disclosure of disciplinary history prior to opening a customer account

Congress should direct the SEC to exercise current rulemaking authority to require a new marketplace disclosure document which explains to investors a broker-dealer and an agent's disciplinary history, so that consumers may make more informed decisions as to where and with whom they want to do business. Disclosure of the disciplinary record should include prior securities and commodity law violations, and any criminal, civil and administrative actions taken against the broker-dealer or agent. A signature should be required as proof that the customer did in fact receive the disclosure document.

Perhaps some people would be more reluctant to turn their money over to a penny stock brokerage firm if they knew beforehand that the firm, for instance (as is true in the case of one major penny stockbrokerage), has been the subject of at least 35 regulatory actions in 29 states since 1979, including fines, license denials, cease and desist orders, injunctions, suspension/revocation, and probationary and conditional registration, as well as the subject of a number of NASD and SEC actions. While state securities agencies routinely provide the disciplinary history of a broker-dealer or agent to people who call their offices seeking it, there is no nation-wide "toll-free" immediate access to this information.
The NASD, since May of last year, has provided this service to investors who know enough to call or write and request the data.

As an alternative to a requirement that a broker-dealer provide this documentation, Congress may instead consider a directive to either the SEC or NASD to establish a toll-free number for customers to call, prior to opening an account, so they may learn the broker-dealer and agent disciplinary information. A broker would be required to notify potential customers that the toll-free service exists. The successful "800" service run by the National Futures Association (NFA) for investors may be considered a model of what is possible in this regard.

4. Existing confirmation slips and account statements should be reworked so that investors have more information concerning the status of their accounts

Legitimate brokerage firms have recognized the utility in providing customers with intelligible and informative monthly account statements so that investors know precisely where their portfolio stands at the end of each month. These brokerage firms have taken the "guessing game" out of reading these monthly account statements. Whether their reason for doing so was for competitive purposes or to be more responsive to customers, the consequence of requiring similar treatment for penny stock investors will be to reveal to these customers the status of their account at any given time. Therefore, ***NASAA recommends that the SEC be directed to require a reworking of existing confirmation slips and account statements*** so that they provide meaningful information to investors.

o ***Monthly customer account statements should clearly indicate the present market value of a customer's holdings.*** Legitimate brokerage firms currently provide this information to their customers; penny stock brokerage firms should do the same.

o ***Confirmation slips should provide clear and meaningful disclosure of markups.*** Penny stock promoters often use arcane and confusing language in transaction confirmation slips to hide basic information about trades. For example, a customer may receive a confirmation which shows no commission, a concept that most people would at least basically understand, but which does include the notation "MARK UP 528.12 RPT PRICE 7/32." What this purports to mean is that the customer paid a total markup of $528.12 and that the markup was based on a reported price of 7/32, $.22 per share. If the total price per share were only 3/4 (or 75 cents), that would be a charge of 43 percent of the unmarked up price. (A "mark up" is the difference between what the market maker paid for the stock and the price at which it is sold.)[21]

o There is ample evidence that some penny stock brokerage firms play "fast and loose" when recording whether a transaction is "solicited" or "unsolicited." Testimony of a former penny stockbroker before a hearing on penny stock issues in the state of Georgia[22] revealed that most internal order tickets were stamped "unsolicited" even where the broker had clearly indicated that it was a solicited trade. Brokerage firms ***should be required, on internal order tickets and customer confirmation slips, to clearly and accurately reflect whether a transaction was "solicited" or "unsolicited."*** NASAA understands that the SEC staff is currently considering such a requirement.

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[21] Equally problematic is that markups that may be claimed on confirmation slips do not always accurately reflect the true price paid by the market maker for the stock. That is because a market maker may "piggyback" onto the price quotes of any other market maker and continue such quotations indefinitely without regard to whether the market maker whose price quotes initially provided the basis for the prices continues to make a market in the security.

[22] See statement of Rick Kayne, "In the Matter of: The Acts, Practices and Transactions Involving the Offer and Sale of Penny Stock within and from the State of Georgia," File Number 59-89-0016, May 10, 1989 pages 56-57.

This recommended four-part marketplace disclosure program should help to eradicate the serious shortage of information about the penny stock market and its participants currently available to consumers.

Prevent "Bad Boys" from entering or continuing in the business

The September 1989 NASAA Report on Fraud and Abuse in the Penny Stock Industry reveals overwhelming evidence that abusive penny stock brokerage operations are hiring, retaining and doing business with a large number of persons with extensive backgrounds of violations of federal and state securities law, felony convictions and ties to organized crime. The Final Report of the Regulatory Review Task Force, released by the NASD in March 1988,[23] identified similar concerns on behalf of the Task Force and recommended changes to help weed out unscrupulous characters from the business.

As part of their overall strategy for policing the penny stock industry, several states have realized the value of preventing certain individuals from participating in the business. NASAA respectfully encourages Congress to consider the following two recommendations to assist in the effort to keep out of the business persons who clearly do not belong in it.

1. Institute more effective sanctions against employment of "consultants" who are otherwise prohibited from the business

One of the most troubling aspects of the penny stock game is that those who run afoul of the securities law manage to ply their trade in one form or another. Most often, they resurface as "consultants" to brokerage firms without actually serving as employees subject to registration requirements. The March 1988 Report of the NASD Regulatory Review Task Force highlighted this problem of illicit re-entry into the business by some persons subject to statutory disqualifications. In their discussion, the Task Force noted that "some firms have resorted to the artifice of 'consultant' status to avoid registration of an associated person who is subject to a bar or suspension." [24]

In an examination earlier this year of a single penny stock firm, investigators for the securities division of the Georgia Secretary of State's Office found that five "consultants" had been employed to carry out a variety of services for the firm, including motivation of salespersons, monitoring tickets from customer trades, preparing financial and assisting in back-office operations. But these were no CPAs or fresh-faced Harvard Business School

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[23] On April 29, 1987, the NASD announced the formation of the a Regulatory Review Task Force to conduct a comprehensive review of the policies, practices and procedures of the NASD and to make recommendations for strengthening the NASD's surveillance and enforcement capabilities. The Task Force reported its findings in the March 1988, Final Report of the Regulatory Review Task Force. Discussion of the "who's in the business" issue can be found in chapters four, five and eight of the report.

[24] Final Report of the Regulatory Review Task Force, NASD, March 1988, page 27.

MBAs. An examination by the Georgia securities division of the five individuals revealed that the quintet of "consultants" had impressive rap sheets, including violations for:

- o Attempted burglary, resulting in civil action;
- o Battery;
- o Felony possession of cocaine;
- o Trafficking in cocaine;
- o Three cease and desist orders from securities agencies in other states;
- o A permanent injunction by another state securities agency;
- o An NASD suspension, censure and fine;
- o State of Georgia order of prohibition and fine;
- o State of Georgia order of censure and fine;
- o State of Georgia order of conditional registration;
- o Numerous resolved and unresolved investor complaints;
- o Enjoining action by the CFTC; and
- o Trespassing after warning.

While a background of this sort would in most instances create a barrier to entry into a legitimate brokerage firm, it seems almost to be a prerequisite for playing a behind-the-scenes role in an unscrupulous penny stock brokerage firm. The names of one or more individuals with a background of violations of securities laws, felony indictments and/or convictions and reported ties to organized crime were found in all but four (83 percent) of the two dozen major penny stock enforcement cases examined in the course of preparing the NASAA Report on Fraud and Abuse in the Penny Stock Industry.

Despite an interpretation of the NASD Board of Governors (under Article V, Section 1 of the NASD Rules of Fair Practice) which admonishes firms not to employ suspended or barred individuals, this practice appears to be widespread. ***NASAA recommends an amendment to existing rules to provide that any person who employs or affiliates with, through any arrangement, including consulting, a person who is known, or in the exercise of reasonable care should be known, to be a suspended or barred person, is subject to the full array of sanctions available under the law.***

While NASAA is not opposed to placing further restrictions on the securities-related activities of barred or suspended persons found to be acting as "consultants" or in other unofficial capacities in the operation of a brokerage firm, we are skeptical that such an approach will have much utility. Clearly, violators of a bar or a suspension have little regard for the sanctions already imposed upon them. Our recommendation is offered in the hope that holding additional persons culpable for such illicit arrangements may more effectively combat this problem.

2. Hike the time allowed for re-entry application

The NASD's Regulatory Review Task Force identified a significant problem with the re-entry process applicable to statutorily disqualified persons. Although Section 15A(g)(2) of the Securities Exchange Act of 1934 allows the NASD to deny registration to a statutorily disqualified person, it establishes no standards for doing so. Similarly, the severity of misconduct that resulted in the statutory disqualification does not foreclose an application for re-entry if an individual succeeds in finding a firm willing to employ him. The NASD's Regulatory Review Task Force concluded that, "Collectively these factors sometimes make it difficult for the NASD (and the Commission) to deny re-entry to persons who were previously adjudicated guilty of serious misconduct."[25]

NASAA recommends, as did the NASD Regulatory Review Task Force, that ***Congress amend the Securities Exchange Act of 1934 to restrict re-entry into the securities business under Section 15A(d)(2) of the Act*** by certain persons who are statutorily disqualified as a consequence of enforcement actions taken by the SEC, a self-regulatory organization, or other government regulators. Specifically, the following categories of statutorily disqualified persons should be precluded from seeking re-entry for a period of **ten years**:

- Persons convicted of a felony regardless of whether the underlying conduct was related to the securities business; and
- Persons receiving a permanent bar as a consequence of an SRO or SEC enforcement proceeding.

Additionally, persons subject to suspensions imposed by the SEC or an SRO should not be allowed to apply for re-entry during the term of the suspension.

Such a statutory change will distinctly set the securities industry apart from professional baseball where Pete Rose, accused of betting on the game and other acts not "in the best interest of baseball," recently was given a permanent ban from the game of professional baseball. However, the "permanent ban" is really a misnomer. The catch: Rose may apply for reinstatement in just one year. Unfortunately, the statutorily disqualifications handed out in the securities business can be equally ineffective in keeping known violators out of the business. Regulatory authorities need to be given additional tools to deny re-entry to those persons who have no place in the securities business.

Finally, and on a related issue, NASAA and the NASD have explored the idea of implementing some type of continuing education requirements for specific registered securities salespersons. We are pleased to report that we have made progress in our discussions and expect that in the near future we will have the final designs for a mutually-agreeable program.

Additional Enforcement Capability

Regulatory officials charged with policing this burgeoning market are woefully understaffed and underfunded. Detecting and proving fraud and manipulation in the penny stock industry can take hundreds of hours of staffpower and years of litigation. And, in some instances, the Commission lacks the authority to adequately punish wrong-doers when caught. In order to assist the Commission's enforcement program, NASAA offers recommendations for enhanced remedies.

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[25] Final Report of the Regulatory Review Task Force, NASD, March 1988, page 26.

1. Congress should explicitly grant the Commission cease and desist authority

Chairman Breeden, in testifying before this Subcommittee last week, requested that the Commission be granted the authority to issue cease and desist orders. ***NASAA recommends Congress explicitly grant the Commission cease and desist authority.*** While the SEC must go to court to request a restraining order requiring violators to halt illegal conducts, most state securities agencies and other federal agencies, such as the Federal Trade Commission (FTC), now have the power to issue such orders when they find evidence of illegal activity. A recent survey responded to by 42 NASAA members, found that states with authority to issue cease and desist orders had done so nearly 1,000 times in the course of one year. As the states have learned, cease and desist authority is a potent weapon in an agency's enforcement arsenal.

2. Authorize the payment of bounties in penny stock cases

The Insider Trading and Securities Fraud Enforcement Act of 1988 gave the SEC an innovative new tool -- authority to award bounty payments -- designed to encourage additional sources of information to assist the Commission in its investigation and development of insider trading cases. Under new Section 21(A), subsection (e) of the Securities Exchange Act of 1934, the Commission may pay informants up to ten percent of the penalty imposed through litigation or settlement. In June of 1988, the Commission approved rules under which bounties may be awarded to tipsters whose information leads to civil insider-trading penalties. At the time the new rules were approved, then-Enforcement Division Director Gary Lynch said agency investigators had received about 25 tips that could be eligible for bounties and that "several of the calls were extremely helpful."

Systemic fraud and abuse in the penny stock industry is every bit as damaging to the integrity and efficiency of our capital markets as the insider trading scandals targeted by the recently established bounty program. Therefore, ***NASAA respectfully urges Congress to extend the concept of a bounty payment program to include tipsters who provide the agency with information that assists the agency in its investigation and development of penny stock fraud cases.***

3. Criminal Sanctions

The Commission traditionally relies on a civil remedy -- the consent injunction -- in its enforcement actions. In a consent injunction, the defendant neither admits nor denies that he ever did anything wrong but promises not to do it in the future. If he is caught engaging in the enjoined behavior, he may be held in contempt and imprisoned.

Joseph Goldstein, associate director of the Commission's Enforcement Division, recently testified to the shortcomings of an enforcement program heavily dependent upon limited civil remedies:

> Too often the Commission's experience is that the people responsible for organizing, financing and executing stock manipulations in penny stocks are not deterred by the civil remedies that are currently available to the Commission. These civil remedies are viewed as part of the cost of doing business.[26]

The Commission is now making more criminal referrals and assisting federal enforcement authorities in their criminal investigations of securities fraud. ***NASAA recommends that Congress encourage the Commission to continue its efforts to seek criminal prosecutions in the penny stock arena.*** The Department of Justice and other federal enforcement authorities should be put on notice that Congress considers penny stock fraud a serious national problem deserving of a vigilant and aggressive program to detect and prosecute wrongdoers.

Securities Industry Arbitration

NASAA respectfully requests that ***Congress consider expressly prohibiting mandatory predispute arbitration agreements*** in customer agreements. Additionally, Congress should direct the SEC to reinstate its previous Rule 15c2-2 which provided:

> . . . (it) shall be a fraudulent, manipulative or deceptive act or practice for a broker or dealer to enter into an agreement with any public customer which purports to bind the customer to the arbitration of future disputes between them arising under the federal securities laws.

NASAA also **encourages continued monitoring** of procedural reforms to the arbitration process and recommends that the following additional reforms be implemented:

- Require broker-dealers to allow customers a choice among the providers of arbitration services;
- Require prospective arbitrators to complete a formal program of training and education;
- Require that publicly-available arbitration award summaries include the names of the arbitrators and how they voted and the name of the attorney who represented the investor;
- Enhance discovery procedures; and

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[26] Statement of Joseph Goldstein, Associate Director, Division of Enforcement, Securities and Exchange Commission, before a House of Representatives Energy and Commerce Subcommittee on Telecommunications and Finance field hearing on penny stock fraud, page 12. The August 21, 1989, hearing held in Portland, Oregon was chaired by Subcommittee member Congressman Ron Wyden.

- Set a schedule of monetary awards that should be awarded in certain circumstances, such as punitive damages, attorneys fees, cost of the proceeding and pre-award interest.

It is the position of NASAA that an arbitration system that is voluntary and fair will benefit both the investor and the securities industry. The recommended reforms will move us closer to that goal.

Pending Legislation

Congress currently is considering at least three pieces of legislation that, while not specifically tailored to penny stock fraud and abuse, may nonetheless greatly assist in the effort to stamp out this problem.

First, ***Congress should adopt The Securities Law Enforcement Remedies Act.*** In July 19, 1989, testimony before the House Energy and Commerce Subcommittee on Telecommunications and Finance, then-SEC Chairman David Ruder said that enactment of this legislation would be "especially useful in dealing with penny stock fraud . . ." Key provisions of the pending legislation would amend the federal securities laws to:

- Authorize the federal courts to impose civil penalties for violations of the federal securities laws;
- Authorize the Commission to impose civil penalties in certain administrative proceedings; and
- Clarify that federal courts can, as ancillary relief in Commission injunctive actions, prohibit an individual from serving as an officer or director of any reporting company.

For the purposes of combatting penny stock fraud, the ability to bar certain individuals from serving as officers or directors of a reporting company may prove to be an effective tool in keeping fraudulent operators out of the business.

Second, ***final action should be taken to adopt key provisions of the International Securities Enforcement Cooperation Act.*** NASAA is encouraged that this legislation has been approved by both the Senate and the House of Representatives. Two elements of this pending legislation will be particularly helpful in state and federal efforts to stop the rising tide of penny stock fraud:

- The explicit authority granted to the Commission to provide documents and other information to foreign and domestic authorities; and
- Amendment of the definition of "statutory disqualification" in Section 3(a)(39) of the Securities Exchange Act of 1934.

State securities administrators have long been concerned about the Commission's ability to freely share information with co-regulators. While the Commission generally grants access to investigative files to certain entities, Section 24(b) of the Exchange Act[27], as well as provisions of the Investment Advisers Act[28], may arguably preclude the disclosure of certain nonpublic documents.

In removing these restrictions on the Commission staff's ability to provide access to its files to domestic and foreign authorities, this legislation would give the Commission rulemaking authority[29] to implement new access procedures. While state securities regulators are generally appreciative of the efforts made by the Commission's staff over the last few years to facilitate access to investigative and enforcement files, we nonetheless welcome improvements which will help expedite the process. After all, sharing information is an important element in the cooperative regulatory and enforcement efforts necessary to keep pace with the growing fraud in the markets.

Section 3(b) of the proposed International Securities Enforcement Cooperation Act would amend the definition of "statutory disqualification" in the Exchange Act by expanding the grounds on which a self-regulatory organization (SRO) could deny a person membership in, participation in, or association with a member of, an SRO.

First, it would include foreign disciplinary actions as a means for denying membership. In addition, a provision in the proposed legislation would help keep unsavory characters out the securities business by adding "any other felony" to the list of crimes that warrant special review. This provision would permit the Commission and SROs to provide special scrutiny of persons who have been convicted of crimes that are not currently specified, such as taking of property, assault, murder and drug trafficking. The proposed amendment would not automatically exclude every person convicted of such a felony from the securities business but rather would permit SROs, subject to Commission review, to consider facts and circumstances surrounding a particular felony and to impose appropriate safeguards to protect the markets and investors from unreasonable risks.

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[27] Section 24(b) of the Exchange Act, 15 U.S.C. 78x(b), makes it unlawful "for any member, officer, or employee of the Commission to disclose to any person other than a member, officer, or employee of the Commission, or to use for personal benefit, any information contained in any application, statement, report, contract, correspondence, notice or other document filed with or otherwise obtained by the Commission (1) in contravention of the rules and regulations of the Commission under [the Freedom of Information Act], or (2) in circumstances where the Commission has determined pursuant to such rules to accord confidential treatment of information."

[28] Section 210(b) of the Investment Advisers Act bars the Commission staff from making public information obtained in an examination or investigation conducted pursuant to that Act, unless the Commission expressly authorizes such disclosure.

[29] H.R. 1396 would provide for the amendment of Section 24 of the Exchange Act by adding a new subsection: "(c) Notwithstanding any other provision of the law, the Commission may, in its discretion and upon a showing that such information is needed, provide all 'records' (as defined in subsection (a)) and other information in its possession to such persons, both domestic and foreign, as the Commission by rule deems appropriate if the person receiving such records or information provides such assurances of confidentiality as the Commission deems appropriate."

Third, ***Congress should adopt legislation to curb the growing problem of telemarketing fraud.*** The House Energy and Commerce Committee has given its approval to H.R. 1354, the Telemarketing Fraud Prevention Act, which would require the Federal Trade Commission to develop the first-ever rules for phone sales orders. Telemarketing plays an important role in the penny stock fraud problem -- so much so that it has been suggested that a more appropriate term for "over-the-counter" trading may be "over-the-telephone" -- since it is literally by phone where thousands of these trades are transacted daily.

However, we are concerned that an amendment to H.R. 1354 approved by the House Energy and Commerce Committee will severely limit the usefulness of the proposed new rules in fighting penny stock and other securities fraud. Essentially, the amendment excludes the securities industry from jurisdiction of the proposed telemarketing rules. If an exemption for certain securities is warranted, and we believe it may be, such an exemption should be fashioned to exempt securities professionals that must be and are actively licensed under the Securities Exchange Act of 1934 or the Investment Advisers Act of 1940. We recommend that an exemption apply only to those professionals who actually have licenses from the SEC or an SRO under SEC oversight. Many telemarketing schemes involve knowing violations of federal securities laws. It is not enough that exempt entities should be licensed; the exemption should apply only to those who must be and actually are licensed.

The scope of the proposed legislation should be broad enough so that it includes investment opportunities and does not carve-out unwarranted exemptions for the sale of securities. State securities jurisdiction extends only to those investments covered by the definition of "securities" in state and federal statutes. Professional confidence men often seek refuge from securities law enforcement actions by claiming that their schemes do not fall within the technical definition of a security. And, much to our dismay, the courts in some instances have agreed with the con artists. For these reasons, NASAA supports comprehensive coverage of legislation aimed at fraudulent telemarketers so as to fill the gaps in regulation governing investment schemes sold by phone.

NASAA respectfully urges Congress to reject legislation approved last week by the Senate Judiciary Committee -- ***the special interest attempts to weaken the civil provisions of the Racketeer Influenced and Corrupt Organizations act***, or RICO, as contained in S. 438. While we understand that this proposal falls most directly within the jurisdiction of the Judiciary Committee, NASAA is compelled to raise the issue with this Subcommittee due to the importance of civil RICO in fighting securities fraud. In an effort to recruit "private attorneys general" to combat white collar investment crime, private civil RICO provides treble damages, costs and attorney fees to private civil litigants who prevail.

While securities fraud spirals off the charts, prosecutorial and regulatory resources remain limited, with little realistic hope of material improvement. Under S. 438, private civil RICO's enhanced remedies for securities, mail and wire fraud would be eliminated in all but the rarest instances. We must finally recognize that a person who engages in a pattern of indictable securities, mail or wire fraud is a real crook.

Finally, NASAA urges Congress to dramatically increase the funding and staffing of the SEC. ***NASAA strongly supports proposals which would move the Commission toward self-funding.*** You are no doubt well aware of the severe staff and budget shortages of the agency, while its responsibilities to oversee and police an expanding marketplace continue to mushroom. Over the years, NASAA consistently has supported increases to the SEC's budget and continues to do so.

The creation of the SEC in the early 1930s was intended, in large part, as a signal to investors that Congress recognized the need for federal oversight of U.S. capital markets. In the 1980s, the budget and staffing of the SEC lagged dangerously far behind the explosive growth of the markets and a parallel surge in investment fraud. SEC staff time devoted to enforcement has edged up just 5 percent since 1980. In the same period, there have been startling and unmatched increases in the markets, in which the number of brokerage firms has shot up 88 percent, the number of stockbrokers has climbed 145 percent and the dollar value of assets under management by investment advisers has skyrocketed an astonishing 945 percent. Self-funding is the vital first step needed to convince investors that the SEC is back on the job.

Conclusion

Reforms that will bring the penny stock market out of the shadows and into the sunshine, as recommended in this testimony, are certain to raise protests from some penny stock brokerage firm officials who defend their products and marketplace by cloaking "venture stocks" -- perhaps the industry's most widely used euphemism for penny stocks -- in the mantle of free enterprise and entrepreneurship. Rather than serving as a source of capital for small, emerging businesses, as these officials contend, the penny stock market appears to serve primarily as a way for hustlers and other con artists to enjoy fancy living with other's money.

Cleaning up the penny stock market is but one goal of the reforms suggested in this testimony. If adopted, these reforms will also help the small investor distinguish between legitimate and fraudulent investment opportunities. Investment banker Felix Rohatyn's advice of one year ago remains relevant today: "Confidence in our financial markets has been an enormous national asset. It fueled our economy during the past 40 years. At a time when the need for domestic investment is very great, that confidence must be restored. And it can only be restored through swift and strong action by regulators, Congress and the White House." The major deficiencies in the penny stock market which pave the way for fraud and manipulation must be corrected if we are truly committed to restoring the integrity of our capital markets and investor confidence in those markets.

Senator **Bryan**. Thank you very much, Ms. Bryant. We appreciate the testimony.

Mr. Wilson, we'll have you bat clean-up on this panel.

STATEMENT OF FRANK J. WILSON, GENERAL COUNSEL AND EXECUTIVE VICE PRESIDENT FOR LAW AND REGULATORY POLICY, NATIONAL ASSOCIATION OF SECURITIES DEALERS, WASHINGTON, DC

Mr. **Wilson**. Thank you, sir.

NASD appreciates the opportunity to come and talk to the committee today relative to the penny stock problem and the legislation proposed to it, as well as arbitration.

Insofar as we can determine, there are roughly 55,000 securities available for public trading in the United States, about 47,000 of which trade outside an exchange or NASDAQ. Many of these are penny stocks, those trading under $3 a share and with few exceptions are not traded on an exchange or NASDAQ.

The penny stocks represent a variety of risks—market domination, price manipulation, overcharging, high-pressure sales tactics, general misrepresentation and fraud, and lack of investment and price information for investors.

Harmed particularly by penny stock abuse are the individuals who are defrauded, the markets for lower-priced securities and those who must use these markets for their capital needs.

The SEC's Rule 15(C)(2)(6), the penny stock rule, directly addresses these problems and the NASD strongly supports it. And I personally believe that it will be an effective deterrent to penny stock fraud.

We have seen encouraging trends in the correction of penny stock abuse in the past year, as evidenced by the fact that the number of penny stock complaints made to the NASD dropped significantly in 1989, and a number of penny stock firms with significant business that we can identify fell from 200 to approximately 100, with probably another 50 or so smaller operators.

Hopefully, these reductions will continue. They resulted from joint efforts by many agencies, including the NASD, the SEC and the States, who have acted jointly in the public interest.

For its part, the NASD has done a number of things detailed in our prepared testimony. Not the least of these is that in the last 3½ years, well over 200 NASD penny stock formal complaints were filed, producing penalties ranging from bars of individuals, expulsions of firms and fines of up to $700,000.

Over 225 additional investigations are currently underway. Other initiatives by the NASD recently are the development of computerized case tracking systems which enables us to coordinate our investigations on a nationwide basis, participating, as I said, in joint investigations and in the Attorney General's Securities and Commodities Working Group.

We've also enhanced the training and member education. We have also established an electronic bulletin board to explore information on non-NASDAQ over-the-counter securities and permit electronic surveillance.

We have also expanded the SEC Rule 19(C) 211 responsibilities so as to require the filing of the information required by that rule with the NASD before publication of any issue in any quotation medium, such as the pink sheets.

This proposal is still awaiting SEC approval.

NASD has also enhanced trade reporting in non-NASDAQ over-the-counter securities where the dealing exceeds 50,000 shares or $10,000. This requirement is used by the NASD to monitor these markets electronically.

The NASD is also the first self-regulatory organization to have implemented a system for disclosure to investors of the broker's disciplinary history. This extremely popular program has processed 12,000 information requests since May 1988.

The NASD is also involved in maintaining a branch office for examinations of abuse of penny stock sales practices in the past year and will assist the SEC in enforcing its penny stock rule through a nationwide special examination program of all penny stock dealers.

Under study now is an upgrading of NASDAQ's qualification standards to prevent that system from being infected by the penny stock malaise.

As to S. 647, the Securities Law Enforcement Remedies Act of 1989, the NASD is in complete support of that proposal as rather in accordance with the amendments suggested by Chairman Breeden last week. Cease and desist authority and fining authority for the NASD is, in my view at least, long overdue.

As to S. 2057, the Small Investor Protection Act of 1990, the NASD supports its goals and believes it contains numerous ideas that can improve the protection of small investors.

Certain aspects of it we believe need further study, however.

As to arbitration, the NASD has sponsored an arbitration program since 1968 that facilitates the resolution of disputes between customers and members, as well as intraindustry disputes.

Currently, this program is the largest in the industry. The NASD believes that the program provides a fair and expeditious forum for the resolution of securities disputes and the SEC has agreed with that assessment.

During the last decade, the program has grown from 318 cases filed in 1980 to almost 4,000 in 1988, and down to about 3,651, or down about 8 percent in 1989. However, the 1989 hearing sessions of arbitration cases increased by 80 percent over 1988.

About two-thirds of all securities arbitration cases were filed with the NASD and a quarter of them were filed with the New York Stock Exchange. In the past 10 years, our arbitration staff has grown eightfold. And turnaround times for cases in the program, all cases, of 11.5 months, or 9.7 months for small investors; turnaround time is continuing to decline.

In 1989, we introduced mediation, a pilot mediation program, as a complement to the arbitration program in an effort to reduce the turnaround time. Those cases that went through the mediation process had a turnaround time of about 8.3 months.

Many improvements to the arbitration system were finalized in 1989. These are detailed in our prepared testimony as well as the SEC's. This doesn't mean to say that more can't be done and we're continually alert for ways to improve and we engage in an ongoing review.

In my view, one of the ways the securities industry arbitration can be improved is by way of creation of a uniform arbitration system. That is, one securities industry arbitration form rather than the nine that currently exist.

This unified system would not be operated by an industry self-regulatory organization. It would have an independent board; perhaps 50 percent of the board would be from the public.

And, hopefully, the perception of fairness for securities industry arbitration would be enhanced. Efficiencies of scale would also obviously result.

In some fashion, however, the industry would for the most part have to fund the system.

SICA, the Securities Industry Conference on Arbitration, recently voted to have a study conducted to determine the best way to achieve this result. The NASD has for several years advocated a single unified industry form that will be an active participant in any study that ensues and will continue to be an active proponent of such a concept.

Thank you, Mr. Chairman. I'll be prepared to answer any questions.

[The complete prepared statement of Frank J. Wilson follows:]

Testimony of Frank J. Wilson
Executive Vice President and General Counsel
National Association of Securities Dealers

Before a Hearing of the
Subcommittee on Securities of the
Committee on Banking, Housing, and Urban Affairs
United States Senate

Concerning

Small Investor Issues

February 8, 1990

SUMMARY OF TESTIMONY

The National Association of Securities Dealers, Inc. (NASD) will focus its remarks on two areas within the NASD's jurisdiction of major concern to the small investor: penny stock fraud and arbitration.

The NASD is registered with the Securities and Exchange Commission (SEC) as a national securities association under the Securities Exchange Act of 1934, and is responsible for regulation of both the National Association of Securities Dealers Automated Quotation System (NASDAQ), which is the second largest securities market in the United States, and the over-the-counter securities markets.

Penny Stock

There are very roughly 55,000 securities available for public trading in the United States, about 47,000 of which trade outside an exchange or NASDAQ. Many of these are penny stocks, which are low priced (usually trading under $3 per share, initially) and, with few exceptions, are not traded on an exchange or quoted on NASDAQ.

Penny stocks present a variety of risks: market domination and price manipulation, overcharging, high pressure sales tactics, general misrepresentation and fraud, and lack of investment and price information for investors. Harmed particularly by penny stock abuse are the individuals who are defrauded, the markets for lower priced securities and those who must use those markets for their capital needs. The SEC's Rule 15c2-6 (Penny Stock Rule) directly addresses these problems and the NASD strongly supports it. We have seen encouraging trends in penny stock abuse in the past year: the number of penny stock complaints made to the NASD dropped by 75% and the number of penny stock firms with significant business fell from 200 to 100.

NASD Penny Stock Fraud Efforts

Enforcement

- NASD Actions - In the last three and one-half years, well over 200 NASD penny stock formal complaints were filed, producing penalties ranging from bars of individuals, expulsions of firms, and fines up to $700,000. Over 225 additional investigations are underway.

- Computerized Case Tracking System - This database allows the NASD to coordinate its Non-NASDAQ Over the Counter (NNOTC) enforcement on a nation-wide basis.

- Joint Investigations - The NASD is also engaged in a number of penny stock joint investigations with the SEC, the FBI, U.S. Attorneys, the IRS, state securities commissions, and state attorneys general.

- Securities and Commodities Fraud Working Group - The NASD is an active participant in this U.S. Department of Justice Working Group.

- Training and Member Education - The NASD is providing special training to its examiners and state and federal regulators, as well as special member education

Prevention in the NNOTC Markets

- Electronic Bulletin Board - The NASD is developing an electronic bulletin board service on NASDAQ for the display of information on NNOTC securities. The subsequent regulation that the NASD can exercise because of it will significantly enhance NNOTC customer protection.

- Expanded Rule 15c2-11 Responsibilities - The NASD recently filed for approval with the SEC amendments to its Bylaws to expand NASD regulatory efforts with a new power to systematically review compliance with SEC Rule 15c2-11.

- Enhanced Trade Reporting - NASD members who execute principal transactions in NNOTC securities are required to report electronically price and volume daily if their aggregate purchases or sales exceed either 50,000 shares or $10,000. This requirement is used by the NASD to monitor these markets electronically.

- Disciplinary Disclosure - The NASD is the first self regulatory organization to have implemented a system for disclosure to investors of a broker's disciplinary history. This extremely popular program has processed 12,000 information requests.

- Enhanced Fine Authority - The NASD's ceiling on fines for rule violations was removed in 1988, and it has thus levied fines up to $700,000.

- Markup Policy Amendment - Penny stock cases typically involve excessive markups, which are governed by NASD policy. The NASD is now reviewing its policy in depth to strengthen and clarify its impact.

- Special Branch and Main Office Sales Practices Examinations The NASD has begun main and branch office examinations for abusive penny stock sales practices in the past year, and will enforce the SEC's Penny Stock Rule with the SEC through a nationwide special examination program of all penny stock dealers.

Protection of the NASDAQ Market

- NASDAQ Standards - Securities that are designated for trading on NASDAQ must meet stated financial requirements, which the NASD is now considering raising.

- Visibility of NASDAQ Quotations - The NASDAQ market, with 195,000 computer screens, is highly visible and so less subject to manipulation.

- Monitoring the NASDAQ Market and Issuers - NASDAQ securities are continuously monitored by 81 staff who use the most sophisticated computer analysis available to track every price move. NASD analysts review each issuer's Form 10-K and 10-Q for the proper disclosure and the propriety of the accounting treatment of every reported material transaction. In 1989, 240 companies were deleted for failure to meet NASDAQ standards.

S 647 Securities Law Enforcement Remedies Act of 1989 The NASD supports S 647 with the amendments that SEC Chairman Breeden proposed last week.

S 2057 Small Investor Protection Act of 1990 While the NASD supports the goals of S 2057 and believes it contains numerous ideas that could improve the protection of small investors, the NASD hopes that it can be reviewed very carefully and at some length. We offer our assistance to the Senate in its review of this bill.

NASD Arbitration

The NASD has sponsored an arbitration program since 1968 that facilitates the resolution of disputes between customers and members, as well as intra-industry disputes. The NASD believes that the program provides a fair and expeditious forum for the resolution of securities disputes.

Program Growth and Claim Resolution Speed During the last decade, the program has grown from 318 cases filed in 1980, to 3,651 cases in 1989. About two-thirds of all securities arbitration cases were filed with the NASD, and a quarter were filed with the New York Stock Exchange. In the last ten years, the NASD's arbitration staff has grown eight fold. The average turnaround time for all cases closed in 1989 was 11.5 months, 9.7 months for small investors.

Program Improvements

- Mediation - The NASD's Pilot Mediation Program was able to reduce the closeout time for arbitration cases settled by mediation to 8.3 months.

- Unified Arbitration Forum - The NASD has been a strong advocate for a Unified Arbitration Forum, which would not be administered by any SRO, and could ensure uniformity and reduce arbitration costs.

- Arbitrators - The NASD has undertaken numerous efforts to train arbitrators, and has begun an arbitrator evaluation program.

Procedural Changes On May 10, 1989, the SEC approved wide ranging rule changes to improve public confidence in the arbitration process. These changes, as well as others made in the previous two years, comprise the areas of: Party Service of Pleadings, Reduction in Arbitrator Panel Size, Simplified Procedures for Replacing Arbitrators, Classification of Arbitrators, Disclosures Required of Arbitrators, Discovery, and Awards.

Pre-Dispute Arbitration Clauses The NASD has adopted rules requiring that these clauses include specific highlighted disclosures, that the customer acknowledge that the signed agreement includes a pre-dispute arbitration clause, and that the customer receive a copy of the agreement.

Additional Areas to be Addressed While progress has been made on rules to promote investor confidence in arbitration, the following areas remain to be addressed: rules to manage large and complex cases, determining whether class actions are proper in an arbitration setting, attracting qualified arbitrators for cases requiring multiple hearing days, possible sanctions against the recalcitrant lawyers who frustrate arbitration proceedings, and limitation of unnecessary postponements of hearings that delay the process.

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I am Frank J. Wilson, General Counsel and Executive Vice President of the National Association of Securities Dealers, Inc. (NASD). The NASD is pleased to have this opportunity to appear before you today to discuss enforcement issues involving small investors in today's markets. My statement today will cover a variety of areas regarding enforcement and small investors, but it will focus on two areas within the NASD's jurisdiction of major concern to the small investor: penny stock fraud and the small investor's seeking of restitution through arbitration.

The NASD

The NASD is registered with the Securities and Exchange Commission (SEC) as a national securities association under the Securities Exchange Act of 1934. The NASD is the only association so registered. It is charged with the responsibility of regulating both the National Association of Securities Dealers Automated Quotation System (NASDAQ), which is the second largest securities market in the United States and the third largest in the world, and the over-the-counter securities markets. This task encompasses both regulation of NASD member broker-dealer firms and the regulation and operation of the NASDAQ system.

The NASD employs about 1,800 people, and has 6,150 broker-dealer members employing 439,000 registered sales persons and principals. Some 5,000 securities issued by 4,300 companies are quoted in the NASDAQ system and 570 NASD members serve as market makers in those securities. The scope of the NASD's regulatory jurisdiction extends to all such members and their regulated persons. While the 2,000 staff of the SEC and the roughly half that number of state securities regulatory staff must deal with all aspects of securities regulation, the 1,800 staff of the NASD focuses on regulation of its members and the operation of its market, which is only a segment of federal and state regulation. Through close cooperation with federal and state regulators, overlap and duplication is minimized, freeing governmental resources for securities regulation to be expended in other areas.

The NASD carries out its examination, disciplinary, and other regulatory responsibilities through its Washington headquarters and 14 District Offices located in major cities throughout the country. In addition to disciplinary committees that work with each District Office, the NASD has a national Market Surveillance Committee that deals specifically with market and trading related issues. A committee of the NASD Board of Governors, the National Business Conduct Committee, reviews as an appellate body the disciplinary activities of the District Business Conduct Committees and the Market Surveillance Committee, and seeks, to the extent possible, uniformity in disciplinary actions. Final NASD disciplinary actions can be appealed to the SEC and then to the United States Courts of Appeals.

NASDAQ is a highly visible electronic market with intense competition between market makers. Their bid and offer quotations are continuously displayed over thousands of subscriber terminals, with real-time transaction reports for all NASDAQ/National Market System stocks. Ownership and participation by investors in the NASDAQ market is broad and diverse. Individual investors hold approximately two-thirds of the market value of NASDAQ stocks. Institutional investors are also very active in NASDAQ, but individual participation is paramount, and thus the NASD is extremely concerned with the problems of small investors in today's markets.

Penny Stock

We estimate that there are very roughly 55,000 securities that are available for public trading in the United States. About 2,240 of these are listed on the New York Stock Exchange, approximately 1,100 are listed on the American Stock Exchange, and another 4,970 are listed on NASDAQ. Approximately 2,700 of these NASDAQ securities are listed on the NASDAQ/National Market System (NMS). The remaining 2,260 NASDAQ securities are traded in "regular NASDAQ". According to research the NASD has performed in preparation for its Electronic Bulletin Board, about 47,000 securities trade in the Non-NASDAQ Over the Counter (NNOTC) market.

In order of the NASD's listing standards and regulation, the NMS securities are clearly the highest ranked, and the NNOTC the lowest:

- NMS securities have extensive listing standards that include both rigorous quantitative and corporate governance requirements that match or exceed those of the American Stock Exchange and all the regional exchanges, and, have the same market information available as issues trading on the New York Stock Exchange as well as other exchanges. For example, NMS securities are subject to last sale reporting, requiring all transactions to be reported within 90 seconds of execution. Market information is also reported in all major newspapers, as well as through a variety of other sources.

- Regular NASDAQ securities also have rigorous quantitative listing requirements, although less rigorous than NMS securities. Additionally, information about the bid and offered prices are available on a real-time basis, with aggregate trades of market makers reported daily, and are widely reported in the press.

- NNOTC securities have no quantitative or corporate governance standards, and information about the markets is available to the public primarily from the daily publication by the National Quotations Bureau or the "pink sheets," rather than from widely available newspaper listings and other sources. For surveillance and regulatory purposes, however, the

NASD began capturing price and volume information in NNOTC securities about one year ago.

Of the 47,000 securities in the NNOTC market, somewhere between 13,000 to 20,000 trade in the "pink sheets". The "pink sheets", so named for the color of the paper on which they are printed, are a list of firms trading those securities published and circulated daily by the National Quotation Bureau (NQB) of Jersey City, New Jersey. A listing is obtained simply by a market maker paying a minimum fee, $74 per month for 10 listings. The NQB describes the pink sheets as a "telephone book of securities", and takes no responsibility for the information that the price quoted in the pink sheets will be honored even by the brokerage firm that submitted the quotation. In each of the last two years about 190 securities entered the NASDAQ system from the pink sheets.

The remaining NNOTC securities do not trade in the pink sheets, and many of those securities have very little liquidity or investor interest. With the inauguration of the NASD's Electronic Bulletin Board service, which I will discuss below, brokers will be able to enter quotations and indications of interest into a computer system for these securities, which will help provide liquidity, investor interest, and much needed electronic surveillance to this market.

The term "penny stock" has a variety of definitions. One of the simplest is provided by the Webster's NewWorld Investment and Securities Dictionary, which defines a penny stock as "a security selling for less than one dollar per share and considered to be very speculative". A more detailed, generally accepted definition is contained in a the SEC publication, Information for Investors: Beware of Penny Stock Fraud!, which updates the stock prices, and incorporates the important aspect of the market in which the security trades. That definition refers to penny stocks as those that are "low priced (usually trading under $3 per share, initially) and, with few exceptions, are not traded on an exchange or quoted on NASDAQ".

Penny Stock Abuse

That same SEC publication also provides a clear catalogue of the risks that penny stocks present: market domination and price manipulation, overcharging, high pressure sales tactics, general misrepresentation and fraud, and lack of investment and price information for investors. In its release 1/ proposing Rule 15c2-6 (Penny Stock Rule), the SEC further explained the potential for abuse in the penny stock market as:

1/ Securities Exchange Act Release No. 26529 (Feb. 8, 1989)

> ... the indiscriminate use by some broker-dealers of high pressure telephone sales campaigns to sell pink sheet stocks issued by small, little known companies, to unsophisticated investors. Many of these stocks are speculative securities that require purchasers to possess a significant degree of expertise, as well as access to information, before an informed investment can be made. The issuers of these securities are rarely followed by professional securities analysts or covered by the financial press. In addition, the small pink sheet issuers are not subject to the Exchange Act periodic reporting requirements, and therefore may not be making publicly available on a regular basis complete information about their operations and financial conditions. As a result, investors may have few reliable sources of information on these companies.

Further, it stated that:

> The potential for mistreatment of investors in cold calls is magnified when the securities being sold are not traded through organized markets and are issued by little known companies, where the risk of loss and the importance of the investment analysis require a careful and unhurried investment decision.

It is important to note that the SEC's rule as adopted defines "designated security" -- those penny stocks that pose the greater risk of fraud -- to specifically exclude those equity securities that are registered on a national securities exchange or authorized for quotation on the NASDAQ system, or whose issuers have more than $2 million in net tangible assets. Explaining the differences between the exchange and NNOTC markets, the SEC stated 2/:

> The non-NASDAQ OTC market does not have reliable quotation or trade information that the public could use to examine the nature of the market. In contrast, firm quotations are readily available in exchange and NASDAQ markets, and all exchange securities and NASDAQ/National Market System securities have minute by minute trade reports that are disseminated to investors. The availability of this information makes possible ongoing electronic surveillance of exchange and NASDAQ markets by the relevant self-regulatory organization ("SRO"). Many unsophisticated investors may not appreciate the vast difference in the nature, market information, and supervision of the market between the exchange and NASDAQ markets, and the non-NASDAQ OTC market.

The Penny Stock Rule also provides exemptions for transactions: 1) with a share price greater than five dollars, 2) where the purchaser is an accredited

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2/ Securities Exchange Act Rel. No. 27160 (Aug. 22, 1989) investor or established customer, 3) not recommended by the broker-dealer 4) by a broker-dealer not a market maker in the designated security and whose sales revenue from designated securities is less than five percent of total markups and commissions from securities sales.

The Penny Stock Rule prohibits a broker-dealer from buying or selling a designated security unless the transaction is exempt as just described or before the transaction, the broker-dealer has approved the customer for designated securities and received written agreement to the transaction from the purchaser. To approve a customer account for designated securities, the broker-dealer must get sufficient information to make a suitability determination, and receive a signed copy of the broker-dealer's determination from the customer.

The complaints that the NASD has received from the first quarter of 1988 until the first quarter of 1989 regarding NNOTC securities almost doubled. Most of these complaints dealt with bad execution, high pressure or false statements, or unauthorized transactions. We are pleased to note that with all of the attention that penny stocks have received recently, this trend has been reversed and dropped during all of 1989, so that NNOTC complaints received in the last quarter were only 27% of what they were in the first quarter, and fell from 51% of all complaints during the first quarter to 31% of all complaints in the last quarter.

Likewise, as a direct result of the investigations and enforcement actions of the NASD, the SEC, states, and others, the number of penny stock dealers has dramatically declined. Currently there are less than 150 penny stock firms that conduct a sufficient level of business in low priced NNOTC securities to be subject to the SEC's Penny Stock Rule. Moreover, less than 100 of these do any significant amount of business, half the number of a year ago.

Penny stock abuse produces serious problems on three levels:

- The individual, small investor who is defrauded of his or her savings. Obviously, this is the most direct impact of penny stock abuse, and often the most tragic.
- The markets that trade lower priced securities and the legitimate small companies who need access to those markets for their capital needs. Since penny stock abuse is committed through market manipulation and fraud connected with small companies, the perception that the markets in which they trade (and the small companies themselves) pose significant problems makes it increasingly difficult and expensive for legitimate small companies to get the capital they need to grow their business. Vigorous enforcement cases and regulatory responses such as the SEC's Penny Stock Rule, which is carefully crafted to narrowly limit its direct impact on legitimate businesses, tend to clean up this market in the longer term and thus will enhance the reputation of these markets. However, in the

shorter term, these actions contribute to the perception that the smaller issuers and the brokers who trade them are not safe places for investment, and thus may restrict capital availability to smaller companies.

- The capital markets in general. Abuse in a segment of the market is generalized to the entire securities market, especially by unsophisticated investors who do not appreciate the differences in protection afforded by the more stringently regulated markets. Individual investors obviously tend to avoid markets that they believe are crooked, denying capital to American businesses through the mechanism of the stock market.

NASD Penny Stock Fraud Efforts

For these reasons, the NASD has been vigorously combatting penny stock fraud for a number of years. The NASD has countered this threat of fraud three ways: Enforcement, Prevention of Fraud in the Non-NASDAQ Market, and Protection of the NASDAQ market.

Enforcement

The NASD has placed increased emphasis on the enforcement of trading and sales practice abuses involving non-NASDAQ over-the-counter securities.

- NASD Actions - In the last three and one-half years, well over 200 NASD penny stock formal complaints were filed, producing penalties ranging from expulsions of firms, bars of individuals, and fines up to $700,000. Specifically, through its District Offices and Market Surveillance and Anti-Fraud Departments, the NASD has recently initiated numerous disciplinary actions involving securities manipulation, fraudulent mark-ups, fraud in the offer and sale of securities, and other abuses in the non-NASDAQ securities market. In addition to the cases that have been concluded, several complaints against members and their associated persons are pending, with over 225 additional investigations currently underway.

- Completed Cases - Although the NASD is not at liberty to comment on individual ongoing cases, the following partial list of cases that the NASD has completed in non-NASDAQ OTC securities illustrates the NASD's enforcement commitment. Its Market Surveillance Committee and various District Business Conduct Committees have instituted formal disciplinary actions on a nationwide basis, made findings and imposed substantial sanctions in cases involving the following penny stock broker-dealers (including numerous associated persons): Brownstone-Smith Securities (Florida); F.D. Roberts Securities, Inc. (New York); Investors Center, Inc. (New York); Diversified Equities Corp. (New York); Bailey, Martin &

Appel, Inc.(Pennsylvania); Creative Securities Corp. (New York); E.C. Farnsworth & Co., Inc. (New York); Equity-One Corp. (Colorado); Patten Securities Corp. (New Jersey); K.A. Knapp & Co. (Michigan); Centennial State Securities (Colorado); Morgan First Securities (Oregon); First Jersey Securities (New York); Blinder, Robinson & Co.(Colorado); Bradstreet Capital, Inc. (Florida); First Southern Investment Corp. (Connecticut); Guardian International Securities (Florida); Huberman Securities (Florida); International Assets Advisory Corp. (Florida); Morgan Gladstone & Co. (Florida); and Parker Jameson Investment Bankers, Inc. (Florida) In the recent F.D Roberts Securities action, for example, five individuals employed by the firm were fined a total of $500,000 and suspended from association with any NASD member for three to five years.

These disciplinary actions encompassed allegations and findings of fraudulent and manipulative practices, including egregiously excessive charges to customers in principal transactions. These fraudulent markups involved mainly NNOTC securities where the markets were dominated and controlled.

- Computerized Case Tracking System - In order to better coordinate NASD investigations and enforcement activities on a nation-wide basis of NNOTC stock problems, the NASD has developed a computerized central database of NASD actions and investigations involving penny stocks and firms that engage primarily or exclusively in penny stock activity since January 1, 1986. This system provides a docket of critical events as well as the current status and results of virtually all NASD fraud or sales/trading practice abuses cases from across the country that involve NNOTC securities. The system includes all 14 District Office, Anti-Fraud and Market Surveillance Department investigations. It is updated monthly and enables the NASD to direct its enforcement efforts more precisely.

- Joint Investigations - In addition to actions taken on its own, the NASD is also engaged in a number of joint investigations with the SEC, the FBI, U.S. Attorneys, the IRS, state securities commissions, state attorneys general, and others on both the civil and criminal side to fight stock abuse in pink sheet securities. For instance, the NASD is taking part in regional penny stock task forces in Florida, Denver, New York/New Jersey, and Los Angeles. The NASD currently has senior enforcement staff specifically assigned on a full time basis to prosecutors' offices to assist in other criminal investigations involving suspected penny stock fraud. The NASD has initiated and cooperated in a number of investigations that involve not only NASD violations, but are resulting in criminal allegations as well. By working directly with the U.S. Attorneys offices on cases that the NASD uncovers, as well assisting the U.S. Attorneys with cases they initiate, the NASD is able to combine its expertise in the securities markets with the powerful investigative tools of subpoena and wiretap available to federal prosecutors to put unscrupulous dealers not only out of business but into jail as well. For example, Eugene Laff, the former chairman of Haas Securities, was recently convicted after a lengthy federal trial in the Southern District of New York. The NASD assisted the US Attorneys office through the investigative stages of that case by providing documentation, trading and transaction data, analysis of that information, and technical assistance unique to manipulation cases throughout the case's preparation. In another example, the NASD assisted in the investigation of possible criminal misconduct of the previously mentioned penny stock dealer F.D. Roberts and its associated persons, many of whom recently pled guilty to securities fraud in criminal cases.

- Securities and Commodities Fraud Working Group - The NASD is an active participant in the U.S. Department of Justice's Securities and Commodities Fraud Working Group, which consists of governmental and other regulatory agencies involved in the prosecution of securities and commodities fraud. The Working Group has stimulated numerous inter-agency referrals and cooperative efforts. It specifically targets criminal abuses and has sponsored training seminars for assistant U.S. Attorneys, and federal, state and foreign regulators at which the NASD has played a major role. The NASD also has provided Working Group agencies with access to the NASD's automated Central Registration Depositary and to NASDAQ and NNOTC surveillance information for the monitoring and reconstruction of trading data.

- Training - Recognizing the need to provide intensified training to its staff about abusive sales and trading practices, the NASD has included in its regular training program for all NASD investigators/examiners a special segment on investigative techniques for penny stock fraud. The NASD has also conducted, in concert with the SEC, special training sessions on abusive practices for FBI agents, assistant U.S. Attorneys, and individual state securities examiners. In addition, the NASD implemented Advanced Examiner Training on Abusive Sales and Trading Practices Program in early 1989. This three day program deals exclusively with complex sales and trading practice abuses, including unsuitable recommendations, fraud in the offer and sale of securities, churning, price manipulation, unauthorized trading, and excessive markups. Training sessions have been held throughout the country for senior District examiners and management staffs.

- Member Education - In the last several years, the NASD has increased its efforts to educate its members about abusive sales and trading practices, particularly in the penny stock area, through a variety of communications, including numerous Notices to Members, Regulatory Alerts, and membership meetings and seminars.

Prevention in the Non-NASDAQ OTC Markets

Enforcement punishes wrongdoing after it occurs, and serves to prevent others from attempting the same illegal behavior. While meaningful disciplinary actions are an essential part of any regulatory plan, they must be combined with improved systems and regulation if prevention of penny stock fraud is to be effective. The NASD has taken a variety of actions here as well.

- Electronic Bulletin Board - The NASD is developing an electronic bulletin board service on NASDAQ for the display of information on non-NASDAQ OTC securities. 3/ Market makers will be able to enter firm quotes, non-firm quotes, and unpriced indications of interest. The market maker can instantly update quotes as changes in the market occur. This added capability and the subsequent regulation that the NASD can exercise because of it will significantly enhance the protection of investors in this category of securities. The technical aspects of the system are completed; SEC approval is pending, and we are expecting it shortly.

- Expanded Rule 15c2-11 Responsibilities - The NASD recently filed for approval with the SEC amendments to its Bylaws to expand NASD regulatory efforts in the penny stock area by providing it with the power to ascertain compliance with SEC Rule 15c2-11. This rule now requires that broker-dealers gather and maintain information before initiating or resuming a quotation for an NNOTC security in a quotation medium. The proposed amendments will require that member firms file Rule 15c2-11 information with the NASD to demonstrate compliance before beginning or resuming quotation of a NNOTC security in any quotation medium. These filings will be reviewed by the NASD's Anti-Fraud Department. This program is intended to establish a systematic review process to assure member firms compliance with the information requirements of the Rule.

- Enhanced Trade Reporting - Since September 1, 1988, members who execute principal transactions in non-NASDAQ securities have been required to report electronically price and volume on a daily basis if their aggregate purchases or sales cleared through the National Securities Clearing Corporation exceed either 50,000 shares or $10,000. This requirement, which is contained in the NASD Bylaws (Schedule H), is used by the NASD Market Surveillance and Anti-Fraud Departments to monitor these markets electronically. It was expanded to all non-NASDAQ OTC companies on August 1, 1989. This price and volume information is subject to computerized review and analysis to identify indications of potential abusive trading and sales practices. This reporting requirement was described by the SEC as representing "a major

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3/ See Securities Exchange Act Release No. 25949 (July 28, 1988) market surveillance development and should significantly improve the SEC's and the NASD's enforcement efforts in the penny stock area." 4/

- Disciplinary Disclosure - The NASD is the first self-regulatory organization to have implemented a disclosure system for investors and others to obtain a broker's disciplinary and employment history, so that investors can tell ahead of time if their broker has had regulatory problems, and thus make an informed decision of whether to use that broker's services. This program has been extremely popular, and has processed 12,000 information requests since the inception of the program in May of 1988.

- Enhanced Fine Authority - The SEC approved the NASD's request to have its ceiling on fines for rule violations removed in October 1988. Previously set at $15,000, the removal of this cap allows the NASD to craft more effective remedial sanctions in cases that involve serious rule violations, which have ranged up to $700,000 in penny stock cases.

- Markup Policy Amendment - One of the typical abuses found in the penny stock market is excessive markups. Section 4 of the NASD Rules of Fair Practice governs allowable markups. The NASD is currently reviewing this policy in depth in an effort to strengthen and clarify its impact.

- Special Branch and Main Office Sales Practices Examinations The NASD has instituted main and branch office examinations that focus specifically on abusive penny stock sales practices. We are concentrating, for example, on branches that solicit sales of blind pools, underwrite best efforts offerings independently of the main office, make markets in penny stocks, engage in secondary market retail activity, and have a large concentration of customer complaints or cause examinations. In 1989 the NASD conducted well over 100 of these special examinations of penny stock firms.

- Penny Stock Rule Examinations - In 1990 the NASD will aggressively enforce the SEC's Penny Stock Rule, which became effective January 1. As part of this effort, the NASD is joining with the SEC to coordinate a nationwide special examination program of all known penny stock dealers to review them for compliance with the Rule. All of the approximately 150 penny stock firms will be subject to these special examinations, which will result in formal disciplinary actions for any abuses they uncover.

4/ Statement of Joseph I. Goldstein, SEC Associate Director of the Division of Enforcement before a Field Hearing of the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, Portland, August 21, 1989.

Protection of the NASDAQ Market

In addition to working to prevent fraud in the Non-NASDAQ OTC market, the NASD continues its efforts to keep similar fraud out of the NASDAQ market. Those wishing to commit penny stock fraud tend, as the SEC has stated, to work outside the exchanges and NASDAQ because those marketplaces provide firm quotes, trade reporting, and computerized monitoring of the markets. These advantages, plus the visibility of the NASDAQ system, and the standards that securities must meet to trade on exchanges and NASDAQ were important reasons for the SEC to exempt those securities from the coverage of its penny stock rule proposal.

- NASDAQ Standards - Securities that are designated for trading on NASDAQ must meet the following basic requirements:

    - Registration of the issuer under Section 12(g)(1) of the Securities Exchange Act of 1934
    - Two registered market makers in the security
    - Public float of 100,000 shares
    - 300 shareholders
    - Total company assets of at least $2 million
    - Capital and surplus of at least $1 million.

  In addition, special NASDAQ requirements apply for particular types of companies or securities, such as insurance company and bank securities, warrants and American Depositary Receipts.

- Visibility of NASDAQ Quotations - It is very difficult to obtain updated, firm quotations on NNOTC securities. The NASDAQ market, on the other hand, is a screen based system that reflects up to the second, firm price information from all market makers in a particular stock. Quotes are continuously updated and displayed on 165,000 computer screens in the United States, and another 30,000 terminals worldwide.

- Impact of Penny Stock Rule - The SEC's Penny Stock Rule is expected to have dramatic effects on abusive penny stock practices. Because that Rule exempts NASDAQ and exchange listed securities from its coverage for the reasons stated above, both the NASD and the SEC are concerned that NNOTC penny stock companies and broker-dealers will try to seek refuge from the SEC Rule on NASDAQ or on an exchange. The NASD is therefore currently reviewing its standards for inclusion on regular

NASDAQ. It is now exploring raising those standards, as well as possibly requiring additional criteria to be met, in order to further strengthen its market and deny the refuge that companies subject to the SEC's Penny Stock Rule may seek.

- Monitoring the NASDAQ Market - Once designated for trading on NASDAQ, these securities are continuously monitored by the NASD. From a regulatory perspective, the 81 staff of the NASD's Market Surveillance Department utilize automated facilities to monitor price and volume data for trading activity in all NASDAQ securities. It uses on-line systems as well as overnight computer reports, and conducts investigations when an analysis of unusual market activity indicates potential rule violations. Every security in the NASDAQ system is programmed with price and volume parameters reflecting historical patterns that are unique to each particular security. Each transaction in a NMS issue is reported to NASDAQ and automatically compared to these price and volume parameters, as well as the inside - or best - prices being quoted in NASDAQ at the time the order was executed. This last sale reporting on NMS also provides an audit trail that can be utilized when questionable activity is suspected. Price and volume anomalies, as well as unusual trading patterns, are automatically reviewed by the NASD's Market Surveillance Department to uncover possible trading violations.

- Enhanced Electronic Surveillance - Market Surveillance Department capabilities have been recently enhanced with the implementation of the StockWatch and Automated Tracking (SWAT) system. SWAT is the most sophisticated system of its kind employed by any regulator overseeing its marketplace. It replaces former generic price and volume parameters with a program specifically tailored to each individual security based on its unique historical trading pattern. It also captures news on line, allowing calculations to include news as a criterion for unusual price of volume movement. The system is based on a model conceived by professors from the Pennsylvania State University and two Nobel Laureates from the Massachusetts Institute of Technology, and calculates the likelihood that each price quotation and each trade report reflects legitimate market forces. "SWAT" uses sophisticated statistical pricing models and automated news feeds to further refine the automated monitoring capabilities in NASDAQ.

- Monitoring NASDAQ Issuers - Each Form 10-K and 10-Q that the company must file with the SEC must also be filed with the NASD. NASD analysts review each of these forms in detail for each of the NASDAQ companies to ensure not only the adequacy of public disclosure, but the propriety of the accounting treatment of every material transaction that is reported. To ensure that these NASD analysts are familiar with the issues, jargon and accounting trends and treatments involved in the companies they are reviewing, each analyst reviews companies of particular industry groups.

This review is not some perfunctory, mechanical analysis that has no impact on those companies designated for trading on NASDAQ; regular NASDAQ companies are constantly reviewed, and, where necessary, deleted from NASDAQ by the NASD for failure to meet maintenance criteria, to make timely filings, or to register as 12(g) reporting companies with the SEC. In 1987, 208 companies were deleted; in 1988, 287 companies, and in 1989, 240 companies.

S 647 Securities Law Enforcement Remedies Act of 1989

The NASD is fully pledged to working with the federal, state, and other regulators toward the elimination of penny stock fraud in our markets. For this reason the NASD strongly supports efforts to enhance the power of federal and state regulators both by increasing the budgets their governments provide for them, and also providing any needed enforcement tools through legislation.

The NASD therefore supports the enactment of S. 647, the Securities Law Enforcement Remedies Act of 1989, with the amendments that SEC Chairman Richard Breeden proposed to you one week ago. As now proposed by the SEC, that bill would permit assessment of new civil money penalties in administrative and civil proceedings under the securities laws, allow the SEC to ask a court to suspend or bar violators from serving as directors or officers of public companies for certain scienter-based fraud provisions, provide express cease and desist authority for the SEC, give the Commission disgorgement order power in administrative proceedings against regulated entities and in cease and desist proceedings, and provide access to grand jury information to the SEC where justified. The NASD points out that similar powers are widely available to other federal government regulatory agencies and are overdue weapons for the SEC's arsenal to combat fraud and market manipulation.

S 2057 Small Investor Protection Act of 1990

The NASD reiterates that it is fully pledged to reduce fraudulent practices that prey on small investors, and has described its numerous activities toward that end above. We therefore support the goals of S 2057, the Small Investor Protection Act of 1990. The bill would outlaw blank check blind pools, require greatly increased disclosures about spreads and disciplinary history, and grant the SEC cease and desist authority, as well as authority to prohibit those convicted of securities fraud from selling or issuing penny stocks, or serving as officers or directors of publicly reporting corporations.

Two of the six sections of the bill -- cease and desist authority, and officer and director bars -- largely duplicate provisions requested by the SEC for S 647, and the NASD believes the SEC versions should be supported. Provisions such as requiring costly telephone disclosure of disciplinary history may unnecessarily place into rigid legislation responses that are now being taken administratively and flexibly by the NASD to successfully address penny stock problems. Other sections of the bill pose potential problems that we have not been able to consider in depth, given the short time that the bill has been available for review. While we believe S 2057 is advanced with the best of intentions, and contains numerous ideas that can further improve the protection of small investors, we believe it should be considered carefully and at length before any of its provisions are enacted into law. We offer our assistance to the Senate and its staff in its review of this bill.

NASD Arbitration

The NASD has sponsored an arbitration program since 1968 that facilitates the resolution of disputes between customers and members, as well as intra-industry disputes. The program has continually improved procedures and increased resources to promote confidence in, and efficiency of, the process. The NASD believes that the program provides a fair and expeditious forum for the resolution of securities disputes.

Program Growth

During the last decade, the program has grown from 318 cases filed in 1980, to 1,400 cases in 1985, 3,990 in 1988, and 3,651 cases in 1989. Although nine self regulatory organizations provide securities arbitration, the NASD and the New York Stock Exchange handle the bulk of the cases. Of the more than 6,000 cases filed in 1989, about two-thirds were filed with the NASD, and a quarter were filed with the New York Stock Exchange. The remainder were filed with the other seven SROs such as the American Stock Exchange, the Chicago Board Options Exchange, and the Pacific Stock Exchange.

As the case load grew, the NASD has budgeted substantial resources to ensure that cases are processed expeditiously. In 1980, the department totaled nine staff members, all assigned to the New York office. By 1989, the department has grown eight-fold to 75 staff members in four locations - New York, Chicago, Fort Lauderdale, and San Francisco. The cost of the program has also increased dramatically during that period. Thus the NASD has expanded the capacity of its arbitration system when necessary to handle the growing number of claims.

Claim Resolution Speed

The average turnaround time for all cases closed in 1989 was 11.5 months. Small investors who use the small claims provisions available to them in arbitration have their cases decided within 9.7 months, which is expected to reduce to 6 months in calendar 1990.

Program Improvements

The NASD has taken a number of steps to improve the administration of its current arbitration program, while at the same time considering other alternatives to the current program structure.

- Mediation - In July, 1989, the NASD embarked on a Pilot Mediation Program in conjunction with the American Arbitration Association and U.S. Arbitration and Mediation Inc. Participation is voluntary and does not result in a binding decision or delay the processing of the arbitration claim. The mediator works with the parties to analyze the risks of litigation and to explore settlement possibilities. The closeout time for arbitration cases settled by mediation was 8.3 months. The NASD believes that the use of mediation early in the process will facilitate the expeditious resolution of cases at reduced expense to the parties.

- Unified Arbitration Forum - The NASD has been a strong advocate for a Unified Arbitration Forum, which would not be administered by any SRO. Such an organization could ensure uniformity in the administration of arbitration rules and procedures as well as eliminate negative perceptions on the fairness of the process. By centralizing all arbitration programs, all SRO's could receive benefits of economies of scale. At its January 1990 meeting, the Securities Industry Conference on Arbitration (SICA) endorsed a study of the factors involved in the establishment of a single arbitration forum and any other alternatives. The study will focus on the cost, funding, legal status governance and oversight of the forum, or alternatives, and any other relevant factors.

- Arbitrators - Arbitrators are not employees of the NASD or other self regulatory organizations. They are volunteers who come from many diverse non-industry groups as well as the industry. These include the American Association of Individual Investors, Institutional Investors, Inc., the American Bar Association as well as local bar associations and local business groups. The NASD also cooperates with other arbitration forums such as the American Arbitration Association and the Society of Maritime Arbitrators, Inc. to broaden its pool of arbitrators.

  SRO arbitrators, and arbitrators in general, are better educated and qualified to deal with complex securities cases than a typical jury. The use of expert arbitrators may reduce expenses for expert witnesses and eliminate simplistic testimony that is needed with a lay jury in a typical trial.

  Arbitrator training has received significant emphasis by the NASD. In 1986, the NASD produced a training film for arbitrators entitled Agents of Fairness. The film emphasizes fairness and the perception of fairness in arbitration procedures. Since 1986, the NASD has conducted 21 arbitrator forums throughout the United States and offered a national arbitration seminar in December 1988. In addition, the NASD has been cooperating with SICA to develop a Manual for Arbitrators. This manual was published in July 1989 and is being distributed to all SRO arbitrators. It will be periodically updated to ensure that it is a comprehensive education tool for arbitrators. Arbitrators are also invited to educational seminars offered by NASD District Offices. These seminars discuss developing securities issues as well as the proper application of industry rules and regulations.

Arbitrator education is not limited to what is provided by the SRO's. NASD arbitrators are kept apprised of seminars offered by the American Arbitration Association and other alternative dispute resolution organizations. Many of our arbitrators use these seminars to refine their skills.

In January 1990, the NASD instituted an arbitrator evaluation program to assess the performance of arbitrators and the arbitration process. The program includes a three tier evaluation process. The forms received to date have been complimentary. The NASD will monitor forms received to determine if rules should be amended or to determine what arbitrator education is needed.

Procedural Changes

Fairness and the perception of fairness in the arbitration process have been of paramount concern to the NASD, and the balance between fairness and the speed of the process is the most difficult problem in the process. This balance has been examined and adjusted numerous times over the last two years. The most sweeping of these changes resulted from the SEC's approval of a variety of rule changes on May 10, 1989.

These new policies and procedures, like all used in the arbitration program, were approved by the NASD Board of Governors upon a recommendation of the National Arbitration Committee, a standing committee of the Board. This committee has the authority to recommend appropriate rules, regulations and procedures to conduct arbitration proceedings as well as to establish a pool of arbitrators. The Committee has twelve members, four of whom -- including the chairman -- represent not the industry but the public. The Chairman is Professor David Lipton of the Catholic University of America School of Law. Professor Lipton has written extensively about the arbitration process and conducted two studies on securities arbitration for the National Institute of Dispute Resolution. The other public members include a retired justice of the District Appellate Court of Illinois; a former Assistant Dean at the Harvard University Graduate School of Business, and a Dean of the University of Pennsylvania Law School.

On May 10, 1989, the SEC approved wide ranging rule changes to improve public confidence in the arbitration process. These changes, as well as others made in the previous two years, include:

- Party Service of Pleadings - Section 25 of the Code of Arbitration Procedure (Code) was amended to require that the parties serve each other with all pleadings filed subsequent to the Statement of Claim. This removes the NASD staff as intermediaries and speeds up the pleadings process.

- Reduction in Arbitrator Panel Size - When first adopted, the Code favored large panels of arbitrators. Claims over $100,000 required five arbitrators, while claims under $2,000 allowed one arbitrator. With the benefit of experience, we have been able to steadily increase this amount. Under the amended rules, a single arbitrator presides on all cases under $10,000, and in cases up to $30,000 unless a party requests three arbitrators. In cases over $30,000, three arbitrators are assigned.

- Simplified Procedures for Replacing Arbitrators - The process has been frequently frustrated when an arbitrator is no longer able to participate after the hearing has begun. In many cases, the hearing has to start again from the beginning with an entirely new panel, slowing the process and increasing costs. New section 24 of the Code now allows the remaining arbitrators to complete the case without a replacement unless there is an objection by a party. If an objection is raised, the arbitrator will be replaced. The hearing will not necessarily start from the beginning, however; the replacement arbitrator will read the transcript or listen to the tape recording of previous testimony, and the parties may request that testimony of key witnesses be reheard.

- Classification of Arbitrators - NASD arbitrators are classified as public arbitrators or industry arbitrators. Where the controversy involves a dispute between or among members or associated persons of NASD members, the panel is all industry arbitrators. When the controversy involves a public customer, a majority of the panel is selected from public arbitrators on the roster.

  Because of SEC concern that arbitration panels include persons who are not so connected with the industry that it may hinder their ability to make independent judgments on specific industry practices, the NASD amended its guidelines to clarify who may qualify as a public arbitrator.

  Section 19 of the Code defines an industry arbitrator as a person who is associated with a member or other broker-dealer, government securities broker-dealer, municipal securities dealer, or who has been associated with one of these organizations within the past three years. An individual may be reclassified as a public arbitrator three years after he or she no longer works for a member, if the new employment is not related to the industry. Industry retirees may not serve as public arbitrators no matter how long they are retired.

Section 19 also prohibits individuals who have close ties with the industry from becoming public arbitrators. This section excludes from the public arbitration rolls attorneys, accountants and other professionals who attribute twenty percent or more of their individual professional work effort to the securities industry within the last two years. Section 19 additionally prohibits spouses or household members of those associated with a registered broker-dealer, municipal securities dealer, or government securities dealer from serving as a public or industry arbitrator.

- Disclosures Required of Arbitrators - All arbitrators must submit biographical information on an arbitrator profile form to the NASD. The arbitrator profile includes educational background, the arbitrator's former employers and a description of any conflicts of interest. Conflicts that must be described include: clients, broker-dealers where the arbitrator has an account, brokerage firms the arbitrator may have brought a proceeding against and brokerage firms in a proceeding where the arbitrator was an expert witness.

Arbitrators are assigned to a particular case by the NASD staff. Before making a call to a potential arbitrator, the staff considers the background and expertise of the arbitrator. The staff provides each prospective arbitrator with information regarding the case, including the names of parties, their lawyers and potential witnesses and the nature of the case. The arbitrator determines if any conflicts exist to preclude the rendering of a fair and impartial decision.

All arbitrators in securities controversies must qualify as impartial, neutral arbitrators. Section 23 of the Code requires that arbitrators must disclose any interests or relationships that are likely to affect their impartiality. The obligation to disclose conflicts is a continuing obligation and includes any information that may surface during the pendency of the hearing itself.

Once a panel is finalized, the parties receive the name and current business affiliation of each arbitrator, 10 years business background and any disclosure that did not disqualify the arbitrator from appointment. The parties may request additional information regarding the arbitrators. Although the rules require that this information be provided 8 business days before the hearing, the NASD regularly provides this biographical information 30 to 60 days prior to the hearing. This allows the parties sufficient time to investigate the background of the arbitrators and their suitability to preside. The parties each have a peremptory challenge and unlimited challenges for cause.

- Discovery - The discovery process under the Code differs from procedures available in civil litigation. Discovery requests should be reasonable, since fishing expeditions lead to objections by adversaries and cause needless delay in the discovery process. Information requests are required to be specific and relate to the matter in controversy. Parties are requested to cooperate with each other in exchanging documents and avoid interfering with the time set for the hearing.

The May 10 amendments to Sections 32 and 33 of the Code made significant changes in pre-hearing matters and discovery. The amendments were adopted to address criticisms regarding the inability of parties to obtain documents or information needed to prove their case prior to the hearing.

Under the amended rules, if a party requests a pre-hearing conference, the Director of Arbitration will refer the case to a staff member, or a single member of the arbitration panel. The single arbitrator acts on behalf of the panel and may issue subpoenas, direct appearances of witnesses and the production of documents and set deadlines for compliance that may be prior to the first scheduled hearing date.

The ability of arbitrators to order depositions is not addressed in the Code. However, amended Section 32 grants the arbitrators the power to issue any order that will expedite the arbitration proceeding. This language is subject to broad interpretation by the arbitrators. The training manual for arbitrators developed by SICA specifically contemplates the ability of arbitrators to order depositions under limited circumstances. The ability to enforce arbitrators' orders for depositions of non-parties or of persons not affiliated with an NASD member may depend upon whether relevant arbitration law provides for depositions in aid of arbitration. Most state statutes limit this authority to non parties unable or unwilling to attend hearings and to perpetuate the testimony of a witness who may be disabled or otherwise unable to attend the hearing.

Section 33 of the Code grants the arbitrators and counsel of record the power of the subpoena process as provided by law. If there is no authority for an attorney of record to issue subpoenas, a party must petition the arbitrators to issue a subpoena. The Code requires the issuing party to provide a copy of the subpoena to all other parties to the case.

If information is requested from a member firm or associated person of a member firm, Section 33 of the Code empowers the arbitrator to issue an

Order requiring the appearance of anyone associated with a member and their records, enforceable by NASD disciplinary proceedings.

An additional amendment to Section 32 requires all parties to exchange documents they will offer in evidence at the hearing and witnesses they will call, except documents and witnesses used in cross-examination or for rebuttal. The exchange must be completed ten days prior to the scheduled hearing date. The arbitrators may preclude any document or witness not identified.

- Awards - Arbitrators are not required to set forth the reasons for their decision. They are required to decide all the issues presented to them. The arbitration award must contain the names of the parties, a summary of the issues in controversy, damages and other relief requested, damages and other relief awarded, a statement of any other issues resolved, names of the arbitrators, the date the claim was filed and the award was rendered, number and dates of hearing sessions, location of hearing, and signatures of the arbitrators.

Arbitrators have broad equity powers to award any relief they deem appropriate. The ability to award some types of relief may, however, be limited by statute. Arbitrators will generally consider awarding interest from the date of the cause of action to the date of the award. A recent amendment to the Code which is currently pending approval by the SEC requires that interest accrue from the date of the award to the date of payment at the legal rate or a rate set by the arbitrator(s).

Arbitrators have granted requests for attorneys fees and punitive damages. A party supports those claims by including in arbitration any statutory provisions supporting such an award. The pro se party is not prejudiced by this recommendation since the arbitrator can take official notice of the law on a particular issue.

A prevailing party must immediately contact the losing party and demand payment. The NASD will begin disciplinary actions against a member or associated person for failure to honor a validly issued award. Such action has resulted in fines, censures, suspensions and expulsion of members. The referral process does not take place until 90 days after the award is rendered. This is the time period allowed for the filing of a motion to vacate under the Federal Arbitration Act (FAA). Congress may wish to consider shortening this time period because a party may delay the payment of an award by utilizing their rights under the FAA.

All awards involving public customers issued since May 10, 1989, including any reports of arbitrators, are publicly available through the NASD offices in Rockville, Maryland. The publicly available award does not include the names of the arbitrators. However, a party in a public customer case may obtain, by request, copies of awards previously rendered by the arbitrators chosen to preside on their case. The time period to raise any peremptory challenge is extended until the parties are provided with these awards.

Pre-Dispute Arbitration Clauses

In July, 1988, the SEC asked all SROs to review pre-dispute arbitration clauses to determine the need for specific regulations on their content and execution. After review, the NASD adopted rules requiring that pre-dispute arbitration clauses include specific disclosures that must be highlighted, that the customer must acknowledge that the signed agreement includes a pre-dispute arbitration clause, and that the customer must receive a copy of the agreement. With proper disclosure, a customer can determine whether to open an account or form a relationship with a member firm that does not utilize pre-dispute arbitration clauses. This NASD rule was effective September 7, 1989.

Additional Areas to be Addressed

While excellent progress has been made to institute rules to promote investor confidence in arbitration, we must continue to review the rules and procedures to ensure the fairness and efficiency of the arbitration process. A few areas need to be addressed, including: rules to manage large and complex cases, determining whether class actions are proper in an arbitration setting, attracting qualified arbitrators for cases requiring multiple hearing days, possible sanctions against the recalcitrant lawyers who frustrate arbitration proceedings, and limitation of unnecessary postponements of hearings that delay the process.

Conclusion

The NASD thanks this Subcommittee for the opportunity to present its views on the issues confronting the small investor. The NASD has undertaken the extensive efforts to combat penny stock fraud that I have described above and pledges to continue those efforts in concert with the SEC, the states, and federal and state prosecutors. The NASD has also focused its attention on improving the fairness, capacity and speed of the arbitration process, and promises not only to continue those efforts but also to explore other alternatives to providing the fair and expeditious resolution of securities disputes that small investors deserve.

I would be pleased to address any questions you may have.

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Senator **Bryan**. Thank you very much, Mr. Wilson.

Let me begin to focus the questions by asking Mr. Goldstein and Mr. Ketchum, with all the problems that we hear in the penny stock market, the pervasiveness, some $2 billion the testimony has been, what is the significance? What is the importance of this market? Is it something that is important in terms of developing the kind of capital that we need? Or is it, frankly, a greater problem as it develops than its public worth?

Mr. **Ketchum**. Well, Chairman Bryan, I would not undervalue the fact that the low-priced issues market continues to be one means by which small corporations gather equity capital. Certainly it's an important and valuable thing for small businesses.

Obviously, many small businesses today look to either bank lending or private lending as alternatives until they reach a size that they can go directly on-to the NASDAQ market or look for an exchange listing.

But there are certainly a number of small businesses who continue to raise capital but are quite legitimate that operate in this market.

We heard during the rule 15c2-6 comment period from a large number of issuers who had gone into the market at that time and feared that they would have been impacted by the initial proposal if they were starting today. And we made some changes to rule 15c2-6 to try to ensure that companies continue to have the ability to access that market.

So I think any steps have to be taken recognizing that there is a legitimate side to the low-priced stock market. But that doesn't mean in any way to undervalue the seriousness of the problem.

Senator **Bryan**. So it's your view that it has a legitimate function in the capital formation market.

Some of the comments that have been received by this subcommittee, Ms. Bryant's comments on behalf of NASAA indicate that we ought to eliminate the blank check blind pool.

What's your response to that, either Mr. Goldstein or Mr. Ketchum?

Mr. **Ketchum**. I'll start again and ask Mr. Goldstein to add on from his experience on the enforcement side.

I think Ms. Bryant is absolutely correct. And to the extent that she identifies a serious problem with respect to the blank check offerings, it is a vehicle that has been used in fraudulent activity, particularly in the penny stock market more and more regularly, and it's a problem that needs to be addressed.

I would note though that definitionally it's not a very easy problem to address; it has to be addressed with care.

I would note though that definitionally it's not a very——

Beyond blank checks there are a wide number of investment partnership deals that have been brought over a period of years that involve blind pools, often with substantial investment histories, usually with a focus on a particular industry—real estate, oil and gas, and the like—but not necessarily assuring that your money will be invested in any particular geographic location or precisely what you're doing.

In addition, many more mature companies raise equity capital for purposes of dealing with operating expenses. Again, trying to define, to ensure that you're not precluding mature companies from raising capital. That I think needs to be done with care.

So we would like to work with you, Senator Bryan, as well as with the committee on those issues. But I certainly agree that there's a problem here that deserves to be addressed.

Mr. **Goldstein**. If I may just add, from the enforcement side, we have seen widespread abuse with blank checks. They are a very popular vehicle for committing penny stock fraud. For that reason, the penny stock task force has asked the Commission's Office of Economic Analysis to take a look at blank checks and to see if, in fact, they are a good vehicle for raising capital and to present us with a study of that so the Commission could take a look at it in some depth to see if further regulatory steps should be taken in light of your proposals to work with you, and we have that kind of information.

Senator **Bryan**. I'd certainly invite your participation. There may be some definitional problems. And I'm not suggesting that S. 2057 may be as artfully crafted as it needs to be, but if we recognize the magnitude of the difficulty Ms. Bryant and her associates have indicated, it's one of the major problems they face at a State level, and I know that to be true from my own experience as one who was involved with the State level prior to coming to the Congress.

We ought not to let the definitional difficulties preclude us from crafting something that will specifically hone in on the problem and not prevent those who have legitimate purposes in participating in that kind of activity from doing so.

One question I have, again, for the SEC, and that is:

There has been some suggestion—as impressive as some of the things that you've done, the cold calling rule, which I support and I think most of us on this subcommittee do—one of the comments is made. And I noticed it in the examples that you submitted to us in your testimony as part of the record are egregious. They must be among the worst. But what I noticed is that there's an absence of criminal prosecution. There tends to be a deference to the injunctive process.

I guess some of us would ask, if these are among the most violative of the abuses that you see, why aren't we seeing more criminal prosecution? Because that doesn't preclude, obviously, a subsequent civil proceeding?

Mr. **Goldstein**. In fact, we are emphasizing criminal prosecutions in this area. There's been a very large increase in the number of access requests that have been approved and made to criminal law enforcement authorities.

As I pointed out earlier, we cooperated in an undercover operation with the U.S. attorney's office in Salt Lake City. We've worked with criminal law enforcement authorities all over the country. In fact, we detailed people to work with U.S. attorney's offices, one person for a period of 2 years, on a very important case that came out of the U.S. attorney's office in New Jersey.

Criminal law enforcement is one of the major emphases of the Penny Stock Task Force. We're conducting a training program which is going on right now in Denver, CO for over 200 participants, including many assistant U.S. attorneys and FBI agents, as well as State securities regulators and State criminal enforcement people.

So there are quite a few criminal investigations ongoing. There's been quite a few criminal cases brought. There's been at least two RICO criminal cases against penny stock manipulators.

And we fully share your view that this is an area that there must be criminal prosecutions to address the problem.

Mr. WILSON. Mr. Chairman, if I may.

Senator BRYAN. Yes, Mr. Wilson.

Mr. WILSON. I would just like to observe that I think, indeed, there is an emphasis on criminal prosecution in the area today, as Mr. Goldstein has said. The NASD has participated with the SEC in those efforts and with the efforts of State prosecutors as well as U.S. attorneys around the country.

In fact, we, today, have several of our staff indefinitely assigned to certain prosecutors' offices in connection with criminal prosecution in the penny stock area.

Senator BRYAN. Mr. Wilson, since you've responded, let me ask you:

One of the concerns that I have, and we've had some experience, it's extremely difficult to get background and history on those who have previous disciplinary actions taken against them. We had a specific case that we were interested in. I must say that we had real difficulty getting that information and I note that, in a number of instances where individuals or firms have a rather extensive background or history, that they kind of work their way back into the marketplace, not as officers or directors but as consultants.

It seems to me that your group would serve a very, very useful purpose in being more aggressive in imposing sanctions on those firms that engage consultants, using that term as a word of art as opposed to an employee, a director or an officer.

That seems to be a pattern emerging.

Would you share with us your observations?

Mr. WILSON. Yes, sir. You asked two questions, I guess. One relating to disciplinary history, and the second relating to consultants.

The NASD has for several years operated the Central Registration Depository. The Central Registration Depository contains the registrations of upward, I think it's today 450,000 or 500,000 people. A part of that system is called The Special Registration Review. And that section contains the disciplinary histories of people who are in the industry.

The NASD, about 2 years ago, introduced a system whereby the public can get information on a registered person, for instance, if a customer commences doing business with a broker, and wants to find out whether he has had a disciplinary background. He can file a form with the NASD broker, they want to find out whether he has had a disciplinary background. He can file a form with the NASD and by return mail get a copy of that broker's disciplinary history.

Since May 1988, we have responded to 12,000 requests for disciplinary history. So that is a lot better than it used to be.

Perhaps it's not perfect yet, but it is a lot better.

Senator **Bryan**. Is that information—let me just interrupt you if I may before you respond to the second part of my question.

Is that information generally available? Can an individual who has a concern about the person that he or she is dealing with, can they access the system and say I'd like to know do you have anything on Mr. Smith?

Mr. **Wilson**. Yes, indeed. If they contact the NASD, the process calls for us to send them a form which they fill out. And we will respond by return mail with the individual's disciplinary history involving final actions. In other words, completely adjudicated cases where penalties have been imposed, or also where criminal penalties have been imposed.

The file covers not only actions taken by self-regulatory organizations, but we get information from the Justice Department and the State Bureaus of Investigations for purposes of listing on the system the criminal violations.

Senator **Bryan**. Let me give you an opportunity to respond to the second half of the question, which does admittedly implicitly contain a criticism.

That is, the use of the consultant loophole, if you will, that seems to me to be a growing problem in this area. And I think you folks can be a part of that solution.

Mr. **Wilson**. Yes. It really isn't a loophole. It's difficult to prove. In other words, what I mean is:

If a person purports to act as a consultant for a firm and that person has been subjected to a bar and if it can be determined that the activities of that person actually fall within the definition of engaging in the investment banking and securities business, we, indeed, do have jurisdiction.

And when we find those situations, we do take action. However, proving those situations is difficult. It wouldn't bother me if Congress decided to extend to consultants the bar.

Senator **Bryan**. Would you have the ability to file the rule and get that additional authority yourself so that you don't have to subject yourself to that burden of proof to put them in that category?

Or is that something that requires enabling legislation by the Congress?

Mr. **Wilson**. As I said, to the extent that they include that they are, indeed, associated with the firm, I think we do have jurisdiction. And perhaps we can take a look at our rules and see if we can't make them a little clearer in that respect.

Mr. **Ketchum**. Chairman Bryan, I think that that may be most possible at the Commission's level and we are looking very carefully at our authority to define terms. Perhaps defining more specifically parts of the existing definition of associated person to address the consultant problem.

We agree very much with you that it is a means to evade a bar and something that should be addressed. That is something that we are looking at, at the present time.

Senator **Bryan**. Ms. Bryant, just a question to you, if I may.

You are on the front line of it at the State level—my sympathy; I have been there myself. What kind of cooperation are you getting these days from Federal authorities? Is it good? Could they do a better job?

Share with us your perspective.

Ms. **Bryant**. I think it can always be better. It has been excellent in this area in the last 2 years. We have had a lot of cooperation in a number of areas.

I think there is always some concern that the SEC have explicit authority to share information with the States. Right now, there is no problem, but we always have concerns. I think particularly in the penny stock area, our laws complement each other very well.

For instance, at the State level, many States already have the ability to bar from association and issue cease and desist orders. And some of our agencies have the ability to go directly into criminal court.

My agency itself can prosecute criminal cases. So in some instances cases are referred at the State level for faster prosecution. I think all that has worked really well.

Senator **Bryan**. I appreciate that.

Mr. Saxon?

Mr. **Saxon**. Yes, if I could just offer a few comments.

I have heard from the SEC on how to deal with the penny stock task force which is taking place, one region being in Florida. I would like to commend the efforts of the SEC and the NASD, and the other Federal agencies such as the FBI and the IRS.

I think the example set in Florida has been very beneficial, and hopefully it will establish some direction for some other regions of the country. I have been overwhelmed by the cooperation we have gotten from the SEC and the NASD. It is very comforting when you get calls from them advising you of situations they have seen, and they feel they do not have the resources or the time to correct or to look into them, and they ask for our cooperation in doing something about it.

You also made a comment regarding the types of individuals who are getting into the system. That is an area that I feel Florida has been very successful in, and that is by not allowing a problem to become a problem. And that is not allowing them to register to begin with.

In the State of Florida in the last year, we denied 116 individuals and companies. Of those 116, 70 were people or companies that were going to be making a market in penny stocks. It has been our experience that having an effective early detection program can go a long way in preventing the kind of problems that we have seen.

Something else we have done is, not to allow these operations to expand once we have identified problems, or to undergo an examination. If we believe there are deficiencies, we go through records. If we have a feeling there may be some sale practice abuses, maybe perhaps market manipulation, any kind of red flag we may see, that may be an indication to us that we do not want to allow expansion.

One of the things these companies need to be successful is, volume. They cannot operate with merely having four or five brokers, they have got to have a syndicated operation with many branches and lots of representatives. So what we have been doing is, denying them the opportunity to expand through branches or by individuals. It has been very successful so far.

Senator **Bryan**. Thank you very much.

Before yielding to Senator Shelby for some questions, we have been joined by two other members of the subcommittee and another member of the full committee.

I would like to now yield to Senator Wirth for any comments he would like to make by way of an opening statement.

Senator **Wirth**. Fine. Thank you, Mr. Chairman.

I thank all the witnesses for being here. I appreciate your help and attention to this situation.

Thank you, Mr. Chairman.

Senator **Bryan**. Thank you very much, Senator Wirth.

Senator Pressler has joined us.

Senator **Pressler**. Thank you, Mr. Chairman. I thank the witnesses very much.

Senator **Bryan**. Senator Graham.

Senator **Graham**. Thank you very much, Mr. Chairman.

I congratulate you very much on holding these hearings. I wish to commend you for inviting Mr. Don Saxon, who has provided great leadership in our State on this very difficult issue.

And for the record, Mr. Chairman, I would like to provide copies of several public service newspaper columns which have been provided by the Florida Controller's Office to alert the public to potential abuses in this area.

Senator **Bryan**. We will make that a part of the record, Senator.

[The information referred to follows:]

MONEY AND CONSUMERS

By Gerald Lewis, Comptroller of Florida

(NOTE TO EDITORS: This is a continuing column produced and distributed by the Comptroller's Office. Please feel free to edit and use the material as you wish since this is public information. If you have suggestions or questions, contact Lisa McKnight, Media Relations Specialist for the Comptroller's Office, at (904) 488-4844.)

Penny-Stock Firms

October 31, 1988

Penny stocks are securities which generally trade at a price range from 1 cent to $5 per share. Most penny stocks are traded over-the-counter, meaning the securities are not listed or traded on an organized exchange such as the New York or American stock exchanges. Instead, penny-stock transactions are conducted through telephone and computer networks connecting individual dealers.

Companies that raise money on the penny-stock market are usually start-up, speculative ventures with no operating history. There is no proven managerial or technical expertise among the corporate officers and key employees. Corporations of penny-stock issuers are often undercapitalized, having virtually no assets other then the money obtained through the offering itself.

It is easy for brokers to manipulate the penny-stock market, and penny stocks lend themselves to excessive mark-ups by dealers. However, low stock price is not necessarily an indication that a company is fraudulent. There are many legitimate companies whose securities trade at low prices. But an unsophisticated investor usually can't distinguish between the two.

Penny-stock brokers typically use high-pressure "boiler room" telephone sales tactics to sell shares of blind pools. Investors are easily lured into speculative ventures because they are not putting much money at risk. Also, victims often are not inclined to complain because the losses suffered would be exceeded by the cost to litigate the case.

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Comptroller Gerald Lewis and the Securities and Exchange Commission (SEC) have formed a Florida enforcement group to address the problem in this state. In addition to the Comptroller's office and the SEC, the group includes the FBI, the National Association of Securities Dealers and the U.S. Attorney's office for the southern district of Florida.

The group is coordinating examinations and enforcement actions involving Florida penny-stock firms, the securities they market and the individuals who seek registration and control of these offices. It also plans to increase public awareness of the problems typically associated with penny-stock firms.

Comptroller Lewis recommends several precautions when dealing with penny-stock dealers:

1) Make sure the person and firm you are dealing with are registered with the state,

2) Watch out for excessive markups, and

3) Find out as much financial background information about the issue as possible before investing.

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MONEY AND CONSUMERS

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Penny Stocks: Risky Business

January 15, 1990

Penny stock investments often represent companies that produce no goods or services - just an idea. An accurate name for penny stocks is "venture stocks." In other words, you give a poorly financed company money whose future prospects are uncertain. It's risky business.

Penny stocks have been around for a long time. Many major companies started off by selling such stocks whose prices range from a few cents to $5 per share. For example, if the company needed $100,000, it may offer one million shares for 10 cents a piece. Penny stocks are not traded on the market. Instead, you buy them from a licensed broker. Unfortunately, one of the most recent investment schemes in Florida is in penny stock fraud.

These manipulative "boiler room" operators use high pressure telephone sales tactics to sell shares of fraudulent stocks. Investors are attracted to these ventures because they are not risking large amounts of money. However, after the customer has sent in his money, he may find out the company has very little capital and the business venture is uncertain.

Recently the state of Florida has undertaken a major campaign against penny stock fraud. A number of investigations, examinations and actions have taken place to rid Florida of fraudulent penny stock companies. Florida is cracking down on this abuse.

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If you plan to deal in the penny stock market, take some precautions. First of all, beware of high pressure telephone calls that promise you a bargain. Next, ask for a prospectus. This is a required document that contains all facts and risks involved in the sale of the stock. Finally, call the Florida Comptroller's hotline number at 1(800)848-3792. Ask the consumer consultant if this person or company is registered with the state. This one free call may save you some money.

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MONEY AND CONSUMERS

By Gerald Lewis, Comptroller of Florida

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Penny Stocks and "Spread"

November 7, 1988

If you're thinking about investing in the penny-stock market, it's important to be informed about "spread." Spread represents the difference between the "ask" price (the price at which you can buy a security) and the "bid" price (the price at which you can sell it).

Penny stocks are securities which trade at a price range from 1 cent to $5. Brokers usually buy large blocks of penny stocks at a low price and sell smaller blocks to their customers at a profit. A broker's spread on a particular stock represents his cost of doing business.

For example, a particular penny stock might be offered at a bid price of $2.00 with an ask price of $2.25. This means you can buy the stock for $2.25 but you can only sell it for $2.00. The 25-cent spread accounts for the broker's risk and cost of trading the stock.

In order to make money on any stock purchase, you should wait to sell until the bid price rises to a level which surpasses the ask price at the time of your investment. Unfortunately, this doesn't always happen.

Part of the reason why spreads are such a problem is the fact that most penny stocks are traded over-the-counter, meaning the securities are not listed on an organized exchange such as the New York or American stock exchanges. Instead, penny-stock transactions are conducted through telephone and computer networks connecting individual dealers.

Most dealers buy huge blocks of penny stocks and sell them at different prices to each investor. Individual market makers (the people within a

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securities firm who set the bid prices) set their own price for each block of stock depending on such factors as supply and demand, cost, and risk factors. Therefore, unless you call around to every dealer which is trading your particular penny stock, it's practically impossible to determine if you're getting a good deal.

Another problem is that most people who invest in penny stocks don't put in huge sums of money. Therefore, they have the illusion that penny stocks are less risky than other investments because their total potential dollar loss is not great.

The point of all these confusing examples is this: The penny-stock market is no place for the unsophisticated investor. It is extremely volatile and complex, and often even the most experienced investors lose money. If you do decide to invest in penny stocks or in any other type of deal, there are some guidelines you can follow to safeguard yourself:

1) Make sure the firm and the agent you're dealing with are registered with the state. Call my toll-free hotline at 1(800)848-3792 to check before you invest.

2) Ask how long the firm has owned the stock. Don't invest until you find out what the "bid" and the "ask" prices are.

3) Ask the agent for all the offering materials and background information he has about the company in which you're investing.

These questions won't guarantee your safety in dealing with penny stocks, but they might help you spot unregistered and corrupt brokers or bad deals BEFORE you lose money.

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FACT SHEET: Penny Stocks

Oct. 27, 1988

Penny stocks are securities which generally trade at a price range from 1 cent to $5 per share. Penny stocks and the over-the-counter market are not synonymous, but most penny stocks are traded over-the-counter. This means the securities are not listed or traded on an organized exchange such as the New York or American stock exchanges. Instead, the securities transactions are conducted through telephone and computer networks connecting individual dealers.

Companies that raise money on the penny stock market are usually start-up, speculative ventures with no operating history. There is no proven managerial or technical expertise among the corporate officers and key employees. Corporations of penny-stock issuers are often undercapitalized, having virtually no assets other then the money obtained through the offering itself.

It is easy for brokers to manipulate the penny stock market, and penny stocks lend themselves to excessive mark-ups by dealers. However, low stock price is not necessarily an indication that a company is fraudulent. There are many legitimate companies whose securities trade at low prices. But an unsophisticated investor usually can't distinguish between the two.

Brokers typically use high-pressure "boiler room" telephone sales tactics to sell shares of blind pools. Investors are easily lured into speculative ventures because they are not putting much money at risk. Also, victims often are not inclined to complain because the losses suffered would be exceeded by the cost to litigate the case.

Comptroller Gerald Lewis recommends several precautions when dealing with penny-stock dealers:

1) Make sure the person and firm you are dealing with are registered [illegible] the state, (Comptroller's toll-free hotline—1(800)848-3792)

2) Watch out for excessive markups, and

3) Find out as much financial background information about the issue as possible before investing.

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Senator **Bryan**. Senator Shelby, I yield to you for questions, sir.

Senator **Shelby**. Thank you, Mr. Chairman.

A lot of people dealing in the penny stock fraud area have said that most—I would not say all, or a lot of the penny stock deals are frauds from the beginning. You know, it is a scheme from the beginning, fraud ab initio.

What is the number one problem of criminal enforcement? How many people have gone to prison because of penny stock fraud? If we are talking about $2 or $3 billion a year, who knows? I have seen these numbers coming out here at the table. If we are talking about that kind of fraud, what is wrong?

We have been reading that a lot of it came out of the Rocky Mountain area for a long time. Most of us have heard of one particular penny stock company coming out of the Denver area. I do not know what has happened there, but there has been widespread publicity on it, and it is $2 or $3 billion of fraud, whether it is in the Rocky Mountain States, whether it is in Florida, or other States. Even my State of Alabama.

Something ought to be done about it. But just going through the so-called arbitration process is not going to do it. Comments?

Mr. **Goldstein**. We agree, Senator Shelby, that more criminal law enforcement has to take place in this area. I think the U.S. attorneys have made a very, very good start.

There are quite a few criminal convictions. I do not know the number of them.

Senator **Shelby**. When you say "a few," how many?

Mr. **Goldstein**. As I say, I do not know the number.

Senator **Shelby**. Can you get me the number?

Mr. **Goldstein**. I know that there have been at least 10 indictments in Salt Lake City. There have been more than that out of New Jersey. There have been quite a few indictments in New York. We expect that there will be more in other areas.

Senator **Shelby**. Do you know of your own knowledge if any of these people have gone to prison?

Mr. **Goldstein**. Yes. A number. There was a sentencing of one recidivist penny stock manipulator in Dallas, TX, who was given a 9-year prison sentence.

Senator **Shelby**. What happens to the victims? You are talking about a lot of people, a lot of older people, their savings and so forth, they are gone. A lot of these firms are not very well endowed with capital.

Is there any civil redress there? Is there any hope to get these people's money back?

Mr. **Goldstein**. That is one of the most unfortunate aspects of this type of crime. The money is dissipated rather rapidly through high commissions, high living, expensive cars, trips. And it is very, very hard to recover it.

Ms. **Bryant**. Could I comment on that?

Senator **Shelby**. Yes, go ahead, Ms. Bryant.

Ms. **Bryant**. One of the things we have tried in the States is an active education program, and it has worked. We are getting calls from people beforehand, asking first for a disciplinary history, which they can get from the States as well as from the NASD.

We have had a number of cases where we could not actually prosecute anyone, because we worked on this before they invest in some of these penny stocks. But it is a tremendous effort, and it really needs to be national in scope, to educate people beforehand.

But after they have taken the money, it is gone.

Senator SHELBY. Mr. Ketchum, what are you all doing there? What about the criminal aspects? Let's focus on that, first.

Mr. KETCHUM. On the criminal aspects, I do not really have much to add to what Mr. Goldstein said, other than noting the other efforts that have been done.

Senator SHELBY. Can you get some statistics for the chairman and the whole committee, on a State-by-State or jurisdiction-by-jurisdiction basis?

Mr. KETCHUM. I would be pleased to.

Senator SHELBY. On who is being prosecuted, who has been to prison, and how many cases are pending, and so forth.

Mr. KETCHUM. Yes, sir, we will be pleased to.

Mr. KETCHUM. I would say, Senator Shelby, on your other question with respect to the problems of compensation for persons who have been injured by penny stock fraud, that that is a serious problem. And that is why the focus, both in enforcement from the examination and the rulemaking standpoint at the SEC is to get into these firms early, before they have had an opportunity to first get so many investor funds and misappropriate them.

That is really the purpose of the types of examination sweeps that have been spoken of.

Senator SHELBY. How do you further regulate them? What do you need to regulate them so that, for the most part, they cannot perpetrate fraud? I think that is very important.

Mr. KETCHUM. It is an important point. I think the rule that we have just adopted and that went into effect at the beginning of January is a critical tool for that, rule 15c2–6. Because it sets out an objective standard that first protects customers by not allowing a broker-dealer to close a trade of penny stock on the phone.

Second, it proposes specific suitability standards. But most importantly from an enforcement and examination standpoint, it gives you something very objective and clearcut, to walk in at an early point and find out whether the firm is complying and to be able to slow down the firm, or shut them down. I think that will help our ability to get into firms early a great deal.

Senator SHELBY. Do any of you have a judgment as to about what percentage of the penny stocks are fraudulently manipulated?

Ms. Bryant?

Ms. BRYANT. I think there are two parts to the penny stock problem. One is the purely fraudulent companies. I am not sure I can give you an actual percentage, but it is probably more than 50 percent of the ones we have seen where the company was a fraud from the beginning.

Senator SHELBY. Have you identified, most of you together, have you identified most of the penny stock fraud? Is there a presumption there that they would have to rebut, to be legitimate?

Ms. BRYANT. Unfortunately, I think you are exactly right. When we see a small company—I cannot really say it is a presumption, but you look at it very closely.

Senator **Shelby**. They are suspect.

Ms. **Bryant**. They are suspect from the beginning, which is what is hurting capital formation.

Senator **Shelby**. Sure. But they should not be, because a lot of small businesses, small areas, have legitimately been involved in penny stocks as a way to raise capital; have they not?

Ms. **Bryant**. Presumably, they have.

Senator **Shelby**. And some of them, I assume, have been run honestly and not manipulated?

Ms. **Bryant**. That is the other half of the problem.

What we have seen is a company that may in fact be legitimate and may have a legitimate business, who sort of somehow gets involved with these promoters who convince them to go public through the penny stock route, through a blind pool or something.

Senator **Shelby**. If you can identify these promoters, why can't you just shut them up? Just nail their doors.

Ms. **Bryant**. Generally, they are undisclosed.

Senator **Shelby**. Boiler room operations?

Ms. **Bryant**. What we see is a prospectus that identifies the legitimate officers and directors, and they are being advised by someone who is not disclosed in the prospectus. And unless you call these people up and say, "Is somebody advising you?" you really do not even find out.

Senator **Shelby**. You find out after they have been victimized, for the most part, or after the fraud is so widespread that the person or boiler room group can move from "X" State to "Y" State?

Ms. **Bryant**. It is the security itself that is causing the problem. They get an initial amount of money, which is usually minimal. And some of these companies have actually been driven into bankruptcy because of this whole scheme.

The company goes public, and the brokers run the price up, way out of reason. So the company might legitimately have a security issue at 5 cents a share that was worth 5 cents a share, and the stock has all of a sudden run up through these schemes and rumors.

Senator **Shelby**. Mr. Goldstein?

Mr. **Goldstein**. If I may make just two comments. One is, with respect to the promoters, as Ms. Bryant said, a lot of them are undisclosed. We had one case where one of the officers of the company was only a figurehead. He was actually a maintenance man who did not recall whether he had ever heard of the company he was an officer of.

We look to see who is behind the scenes. And when we are sure that there is an undisclosed promoter it can be a very effective criminal case.

But additionally, I want to emphasize that the Enforcement Remedies Act would be a tremendous tool for us, because this would enable us to get in quickly and stop one of these operations by the use of cease and desist authority, as well as the penalty provisions which would enable us to make the cost of committing these kinds of fraud much higher for the people who engage in that kind of conduct.

For those reasons, it would be very helpful, as well as for providing greater access to grand jury information. Frequently, we will have somebody working with an Assistant U.S. Attorney who will have access to information that we cannot use, even after the U.S. attorney has finished his case.

Senator **Shelby**. From what I have read and heard here today, it is going to take more than just civil activity on your part to shut these people down. They have basically a criminal enterprise going, and it is going to take prosecution to take them off the street.

Ms. **Bryant**. That is right.

Mr. **Saxon**. If I could comment on your assumption of guilt——

Senator **Shelby**. We know what the Constitution is. But we have to understand, how do you look at it.

Mr. **Saxon**. In Florida at this point, it is probably a presumption of guilt. And I will explain why, if I may qualify.

In Florida, we have an examination program, unlike perhaps many other States. We have an examination staff of 30 people. Our examinations are all for cause. In other words, we do not go into an institution unless we believe there is a problem.

The ways we find out about problems are threefold: We receive things through newspaper publication, those that appear to be too good to be true; we get referrals from the other regulatory agencies, such as the NASD and the criminal enforcement agencies, and also from the public. In Florida, we believe that there are 3 percent of all licensed dealers specializing in the marketing of penny stocks. Three percent is about 90 companies. However, those 90 companies, out of a total of 3,000, account for over 30 percent of all the complaints we receive.

We look at the examinations we have done where we have taken action. Last year, we named 145 individuals or companies where we sought to revoke or suspend their license, or to administer a fine. Of those 145, 127 were individuals or companies that specialized in penny stocks. That is 88 percent.

So I think it stands to reason as to why there is a presumption that with these types of companies there are problems. And it is very unfortunate to the traditional and legal system, as to the way the companies need to be available to market these types of small companies for capital formation.

I do not think there is any State in the Union that does not want to have the opportunity for capital growth in their areas. And it is a very unfortunate result of the kinds of things we have seen in this area.

Mr. **Wilson**. I was going to offer the observation that I think you put your finger on one of the problems that flows out from the penny market abuses. That is that all stocks, the stocks of all companies that sell for low prices are not necessarily penny stock fraud cases.

Senator **Shelby**. But how do you separate them?

Mr. **Wilson**. That is the problem. That is what I was going to say. However, they get painted with the same broad brush that the others are painted with, and that is unfortunate. I do not know how you correct that.

I think one of the problems that the SEC probably wrestled with when it was developing this rule 15C2-6 was the definition of the stocks you are trying to get at. Everybody knows what you are trying to shoot at, but it is very difficult to define without lumping in some of the good companies as well.

I personally believe, though, that after 15C2-6 has the ability to work, after experience is gained in it, I think that it is going to be one of the most effective deterrents to penny stock fraud. Will it eliminate it? No, it will not eliminate it. But I think it will go a long way toward reducing it.

Also, I think that if this Congress gives the SEC cease and desist authority, as I believe Mr. Goldstein and Mr. Ketchum said, I think that will be very effective as well. It will enable the SEC to take almost immediate action in certain cases.

Senator SHELBY. $2 to $3 billion a year in fraudulent money made off of the consumers in America. That is not peanuts, is it?

Mr. WILSON. It is not peanuts.

Senator SHELBY. It is big business.

Mr. Saxon?

Mr. SAXON. If I could make one final comment on that issue.

I think in many respects you may want to look at the situation with penny stocks the way you might want to look at the drug problem. The simplest way to take care of the drug problem is to get rid of the drugs, and the best way to get rid of the penny stock problem is to get rid of the kind of issues that they are allowed to bring to market.

I am talking about blank checks and blind pools. I think that is where we really need to concentrate our efforts to eliminate the problem.

Senator SHELBY. Thank you, Mr. Chairman.

Senator BRYAN. Thank you very much, Senator Shelby.

Senator Pressler.

Senator PRESSLER. I have no questions at this time.

Senator BRYAN. Senator Graham.

Senator GRAHAM. No questions.

Senator BRYAN. We thank you very much. We are going to leave an opportunity for members of the subcommittee who were not able to join us today to file any questions that they may have.

We certainly appreciate your response to their questions as well, and we appreciate very much your comments and your testimony, and look forward to working with you.

Senator BRYAN. Our second panel this morning consists of Mr. Brian Smiley, an attorney with the law firm of Paige and Bacek in Atlanta, GA, who has an extensive background on security enforcement issues. And we are going to be joined by two victims this morning of penny stock fraud, Mr. and Mrs. Bobby Thomason of Elberton, GA; and Mr. Hartley Bernstein, a partner in the law firm of Brandeis and Bernstein, who also has some experience and background representing individuals on small investment fraud cases.

Good morning. Welcome to the hearing. Mrs. Thomason, if you would feel more comfortable sitting next to your lawyer, that is fine. I am told you performed marvelously for 2 hours of cross-examination. I can assure you that our hearing this morning will not be of a similar vein.

We had a hearing out in Nevada in which we heard from a couple of witnesses who had experiences somewhat similar to your own. So I take it, that must be Mr. Thomason. Welcome.

We will want to hear from the two of you first. It looks like, Mrs. Thomason, you have a statement that you would like to share with us, so let us invite you to proceed.

STATEMENT OF DEBORAH THOMASON, ON BEHALF OF HERSELF AND HER HUSBAND, BOBBY THOMASON, ELBERTON, GA

Mrs. THOMASON. My name is Deborah Thomason. My husband, Bobby, and I, along with our 15-year-old son, Michael, live in Elberton, GA, a small town approximately 100 miles east of Atlanta.

I am a secretary, and my husband is an electrician. My husband is also a Vietnam veteran, whose awards include the combat infantryman badge, the Bronze Star, the Army commendation medal, and a Purple Heart.

In the fall of 1986, we received a telephone call from a man who described himself as a broker with Blinder Robinson, which he said was one of the fastest growing brokerage firms in the United States. In the first call, he did not try to sell us anything. He did inquire about our financial situation.

I told him that my husband and I were not wealthy. I told him that we had never invested in the stock market. We only had our money in CD's and money market accounts. It took us 15 years to save what we had. I told him that we had a son who we wanted to send to college, and I was trying to help out with expenses for my mother, who is suffering in the later stages of Alzheimer's disease.

In order to convince us to purchase stock from him, he made me statements that we later learned were misleading, at best. He told us that investments with him would be safe, and that we would earn a better-return than if we left our money in bank CD's or money market accounts. He told us that we would quickly double our money on stocks he recommended.

He said he was paid a salary, not a commission, such as Merrill Lynch charged. In fact, he said he could save us a fortune over the commissions charged by firms like Merrill Lynch. We later learned that in about 15 months Blinder charged us almost $8,000 in commissions.

When we were thinking about investing in stocks, my husband spoke to a man who had done well in the stock market. He told Bobby that the Southern Co., a utility, was a good stock, because it paid good dividends. When we mentioned this to our broker, he was very turned off by this stock. He said he could recommend better stocks for us.

Our broker never told us that the stocks he was recommending that we buy were very risky. He sold us warrants, and did not tell us that they were even more risky than the stocks. He never told us that, because of the difference between the bid price and what we were charged, we often lost half of our investment as soon as we bought a stock.

Our broker never told us how bad some of these companies were. Only later did we learn, for example, that many of the companies were not profitable, and even were in trouble with the IRS for not paying withholding taxes.

After purchasing several of his recommended stocks, we noticed that nothing he had told us about these stocks seemed to be accurate. They steadily declined in value. When we tried to phone him, he was very hard to reach, and did not return my calls.

We began to complain, and he said that we had to be more patient, because he was going to give us some new stock issues. He told us that the new stock issue always doubled in price overnight. This was one case where he did tell the truth.

The new issue stock he bought for us almost doubled overnight in price. The broker called us the next day, and wanted us to sell. We explained that since this was the only stock in which we had made a profit, we wanted to keep it for a while. He got very upset with me, and began to tell me about the "ABC" plan.

He said that when "A" bought new issue stock, he had to sell it so that "B" and then "C" could make money on the stock. He said that all of his clients wanted to share in the profits of this new issue, and I would have to play by his rules if I ever wanted to receive any new issues again.

He told me that we were greedy because we wanted to hold onto our new issue. He made it plain to me that, if I wanted him to watch my account, I would have to sell the new issue.

I was feeling manipulated, and found it strange that such conditions were attached to new issue stock. I called the broker's manager to complain. The manager said that he agreed with the broker. He said the broker should have explained the "ABC" plan to me before I made the purchase, and should have told me that when you buy new issue stock you had to sell on demand.

We were very unhappy with this broker, and felt that he no longer had our best interests at heart. We called another Blinder Robinson office, and told the receptionist we wanted to speak to the best broker in the office. This broker checked on our account, and said, indeed, that we had been put in several bad positions, but "he could make us well."

At his request, we switched our account to him. He said that we would have to sell most of the stocks the other broker had put us in, so we could buy stocks that he knew about. In fact, he got us to sell out of a stock the first broker sold us by saying that the president of the company was ripping it off.

He then got us to invest the money we got from selling this stock in other stocks. We told him we did not want to risk any more losses. He told me that if we purchased his stocks that he knew about, he could keep an eye on them, and if the stocks started to drop he and the other brokers in his office would just put a hold on them.

This made us feel very safe. We did not realize that this was not legal. It was just a matter of time before we realized that we were lied to again. The second broker had put us in the same kind of investments as the first. He never told us how risky the stocks were.

We finally realized that the brokers were only doing what Blinder Robinson as a company wanted them to do. We knew that we were in trouble when we saw an article in a newspaper that said a lot of people in New Jersey or Pennsylvania were suing Blinder Robinson. We called this man who filed the suit, and he described what had happened. He indicated that the same things had been done to him.

This whole experience has been very difficult for us. We lost over $17,000, which was most of what we had invested. That was money that we needed and had saved for over 15 years. It was to be used to educate our son, and maybe to allow me to go back to college.

When I thought we had lost it, I got physically sick. Losing the money was terrible, being lied to and misled by people we thought we could trust was worse. People who said they did not earn commissions turned out to be making thousands of dollars. Blinder Robinson sold us stocks that its brokers said were great deals, but we were charged as much as five times the price Blinder would have to pay for the same stock on the same day.

Investments we were told were safe, turned out to be in terrible companies. We were very fortunate that we were put in contact with some very knowledgeable attorneys who, upon hearing our story, offered to help us. Fortunately for us, our attorneys were able to recover our monetary losses, and even some attorneys' fees, through arbitration.

Although this process took a long time, we nevertheless felt it was a fair procedure. It worries us that others who have been lied to or who may have been lied to may never be able to recover their money.

Our hope is that laws can be made to put penny stock con men out of business, so that others will not have to go through this agony.

Senator BRYAN. Thank you very much, Mrs. Thomason. You probably mentioned it, and I may have missed it. How was it that you first became acquainted with the first broker?

Mrs. THOMASON. He called me at the office where I work.

Senator BRYAN. Had you had any prior dealings at all with either him or the firm?

Mrs. THOMASON. No, sir.

Senator BRYAN. So it was just literally a cold call, soliciting your business?

Mrs. THOMASON. Yes, sir.

Senator BRYAN. Mr. Thomason, is there anything you would care to add to what Mrs. Thomason had to say?

Mr. THOMASON. No, sir. Not really. Basically, the only thing I can tell you is that we are just lower middle income people, we work for a living, we are not asking for anything. Thanks to our attorneys, we recovered our money. But we are just here hoping that maybe someone else will not have to go through what we did.

It was a traumatic experience for us. It takes a long time for people to save money, when you do not make a lot of money. We are very conservative. We felt like we were making some very good investments with people who called themselves investment bankers. And that is basically it.

I guess it all boils down to—the question you have probably got is: Why did you do this? The only thing I can tell you is that we trusted these people, just the same way you would trust your doctor or you would trust your mechanic. For instance, if you took your car in and he said it needed brakes, you are not going to sit there with him and argue about it. If it needs brakes, you put on brakes.

So that basically is what happened. We trusted them, and they took advantage of us.

Senator **Bryan**. As I know you know, Mr. Thomason, your situation, unhappily, is not an isolated one.

Mr. **Thomason**. Yes, sir. I am well aware of that.

Senator **Bryan**. The testimony before you arrived indicates that nationally the problem may range from $2 to $3 billion annually. There is a lot of people like the two of you. And many others, unfortunately, do not have the same positive or happy ending to the story. You got your money back, through the good work of your attorney and his efforts. But a lot of those do not have that.

We really appreciate both of you coming up this morning. I know it is not easy. But it is important that our record reflect the real experience that someone has had. I think we all get a better understanding as to how this occurs when we talk with people like yourself.

Mr. Smiley, why don't you pick it up from there, and share with us your perspective. You have gone through this and had a great deal of experience and background, and you have heard the testimony this morning. You are well versed in this issue.

What do we need to do to prevent Mr. and Mrs. Thomason's and this country from being ripped off by these kind of con men?

STATEMENT OF BRIAN SMILEY, ATTORNEY WITH THE LAW FIRM OF PAGE & BACEK, ATLANTA, GA

Mr. **Smiley**. I think the first thing you ought to appreciate is that the penny stock market is not really a legitimate market. There may be individual low-priced stocks that are sold legitimately by legitimate firms for fair prices. Major brokerage firms tend to shun low-priced stocks, because they realize they are speculative and they tend to require a lot of due diligence, and they worry a lot about suitability. But they do market legitimate low-priced stocks.

The problem you have got to identify is that you have these firms that specialize in low-priced penny stocks. They call themselves "full service brokerage firms." They call themselves "investment bankers." They are really not. They are retail outlets, and they sell off of their shelf. What is on their shelf are penny stocks. These stocks may be for blank checks, they may be blind pools, they may be companies that cannot pay their withholding taxes, they may be companies whose officers are under indictment.

Those major penny stock firms employ hundreds and even thousands of stock brokers. And they are the penny stock market in this country right now. That is the focus.

To expand a bit, you have also got to realize that the victims of penny stock firms run the full gamut. People like Bob and Deborah Thomason, an electrician and a secretary, are like some of our clients. We have represented military personnel, we have represented engineers, we have also represented accountants and lawyers.

Now, how did accountants and lawyers lose their money to penny stock scams? The answer is, it is a very elaborate ruse. It is not that easy to distinguish a legitimate low-priced stock from an illegitimate one.

The problem is that the penny stock business is probably the most profitable sector of the retail securities business in the country right now. The reason it is so profitable is that it is completely possible to hide the profits that these penny stock firms are making. The way they hide the profits is, the spread.

We had a case in which a penny stock broker, under cross-examination, described the spread as the "dirty little secret of the penny stock industry." The spread is the difference between the bid price, which is what a firm pays for its stock, and the asking price, what it charges the customer. The spreads in penny stocks are outrageous, and in my experience they are never disclosed.

In the Thomason case, they bought stock called "Telephone Express." Now, years ago the NASD charged Blinder Robinson for misleading mark-ups on Telephone Express. So this is the same company years after this proceeding was initiated. They paid an asking price of 3¾ cents per stock, they bought 25,000 shares, they were not told that the bid price on that stock, the price Blinder was paying for the same stock, was only a quarter of a cent. That means that before the ink was dry on their check to Blinder Robinson, they had lost 80 percent of their investment dollar.

Now, most people I know who buy a car get upset when they drive off the lot and it depreciates by 10 percent. Who in the world would invest in a stock, an investment vehicle, if you knew you were going to lose 80 percent the moment you gave the firm your money? As I said, I have never spoken to a penny stock investor who was told about the spread.

The horror of all this is that the greater the spread, the greater the potential for firm profits. The retail brokers, the guys who get on the telephone and call Bob and Deborah Thomason and make 100 phone calls a day to cold call people on penny stocks, they get their commissions usually based on 50 percent of the firm profit. So the bigger the spread on the stock, the bigger the profit to the guy who is selling it to you.

There is a real problem right now under the regulations that the SEC has concerning confirmation slips. In effect, there are some artificial distinctions between mark-up, which is what you have on the principal trades, and the commissions, which is what you have on agency trades. The result is that, when people like the Thomasons bought a stock from Blinder Robinson, they got a confirmation slip that showed nothing as commissions.

Yet the firm's records which we obtained in discovering reveal that in one case where they sold a stock, there was a $5,000 trade, and $1,200 was paid as a commission on that stock, and that commission wasn't revealed to them. That is the dirty little secret of the industry.

Something has to be done so that investors know exactly how their broker is being compensated. Obviously, if a stock has a 30, 40, 50 percent profit built in it, you know that it is not likely to appreciate in value any time soon.

You have heard from the SEC and the State regulators how bad some of these stocks are. You almost want to laugh when you read the underlying documentation that the customer never sees about these companies. We have had clients who invested in blind pool companies whose officers included construction supervisors, back-up singers, people with no experience in business.

But the big problem, the one you need to focus on, is the market manipulation aspect. The problem here is that the penny stock dealers control the supply of the stock, because they usually take it public and they control the float. They also control the demand.

The way they control the demand is through telephone sales campaigns, which are full of misinformation and deceit. You can look at script books that these brokerage firms use. These brokers are trained to imply that you can get 30, 40, 50 percent returns on your money by investing in these penny stock companies, with minimal risk. And they are even trained to urge people to liquidate existing assets so that they can come up with the funds to take part in these tremendous opportunities.

The manipulation there is rampant. Sometimes it is even more blatant. We have seen cases where pink sheet market makers were given outright bribes to list the stocks at particular prices, even though there were no transactions going on.

If I had to summarize it, I would say that this is an ongoing criminal enterprise, an observation that has been made already by others. It is racketeering. It is on a grand scale. The poor investor does not have a chance in dealing with these people. The fraud is too subtle, it is too well orchestrated. And frankly, although there are occasional successes in the civil arena—I am glad we were able to get back to the Thomasons some of their money, but certainly it was not compensation for what they went through when they thought they had lost 15 years of their life savings. I do not think anything will ever compensate them for that.

While there are some civil remedies, the problem cannot be addressed by lawsuits, and cannot be addressed by arbitration. It has got to be addressed by putting these people in jail.

Thank you.

[The complete statement of Brian Smiley follows:]

WRITTEN STATEMENT OF BRIAN N. SMILEY* TO THE SUBCOMMITTEE ON SECURITIES OF THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

Over the past several years, the clients of our law firm have been men and women from all walks of life who have lost money in the penny stock market. Some are working class, some lack college educations, and some do not have high school diplomas. On the other hand, many of our clients are affluent, well educated individuals, including doctors, lawyers, corporate executives and accountants. The penny stock game is so devious that even sophisticated, but trusting, individuals can be duped by it.

From speaking to many penny stock investors, cross-examining the people who sell these stocks, and reviewing documents obtained in discovery,we have noticed patterns of fraudulent conduct. These patterns appear to permeate the penny stock industry.

The Three Call Technique

Most of our clients did not go looking for a stockbroker. Rather, each was the victim of a "cold call." A successful penny stock salesman is almost always a "cold call" artist. When we have cross-examined penny stock brokers, we have learned that their "training" has almost nothing to do with securities analysis and securities law compliance. The emphasis is almost exclusively on cold calling techniques. Manuals, tapes, and scripts are provided to teach rookie brokers how to sell more persuasively over the telephone.

Many brokers utilize a three call system. Some variations exist, but the basic methodology and scripts are similar. As the training manual for one major penny stock firm states, "The Three Call System is designed to soften the approach made by cold calling . . . The Three Call System establishes credibility while it builds rapport with the prospect." In reality, cold calling techniques are a form of psychological warfare, in which the investor's natural skepticism is overcome by verbal tricks and outright deceptions.

Call One

The first call is designed to make a confidence-building introduction to a prospect and to determine if he is a "qualified" investor, but only in the sense that he has money. During this call, the broker introduces himself and his firm.

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* Partner, Page & Bacek, Atlanta, Georgia

A sample script from a large penny stock firm advises its brokers to use the following words to attract the interest of a cold-called prospect:

> Hello, is this Mr. ___________? (First Name) this is ____________ with [Name of brokerage firm deleted] Investment Bankers, in (City).
>
> (First Name) . . pause . . Before I go any further, I want you to relax. I'm not calling to sell you anything today. My firm has been quite successful in it's [sic] recommendations. (In fact, our last issue sold out in only ___________________! In fact, I'm finding it quite easy to open new accounts because of them.)
>
> The reason I am calling is that I would like to know if, when the next interesting opportunity develops, would you like to hear about it also?
>
> Before I return a phone call or put anything in the mail, let me ask two qualifying questions.
>
> - Would you say you were an above average investor? (Yes or no . . . it doesn't matter.)
> - Fine, and would you be likely to be liquid enough to afford a $10,000 minimum investment to open an account if we could both agree on a good potential money maker?

The first call of the three call system is the opening round in a campaign of disinformation. Contrary to what the script implies, the penny stock broker is not watching the market to choose the right moment to make a recommendation from the thousands of available investment opportunities. Rather, the broker is setting up the prospect so that he can be persuaded to buy one of the stocks in which the penny firm makes a market. The penny stock broker is not in the business of giving out disinterested investment advice. The odds are that the only stocks that he will recommend will come from his firm's inventory, unless half-hearted recommendations of other securities are made as "window dressing."

Penny stock brokers ignore the stocks of well-known companies with good track records in favor of those of speculative or even bogus companies whose stocks are carried in the inventory of the brokerage. In fact, in many instances our clients (such as the Thomasons) have reported that when they asked their penny broker about investing in a well-known stock, the broker talked them out of such prudent investments. The brokers did not reveal that while the brokerage might earn a 1 to 3 percent commission on an exchange-listed stock, commissions on penny stocks often exceed thirty percent and can go as high as seventy percent.

Call Two

The purpose of the second call is to establish rapport with the investor, give him the feeling the broker is looking for promising investments, and get a better idea of how much money he can invest. The call may begin with a few friendly questions or comments of a personal nature. According to one training manual, the broker should "Help your clients feel important. Put their needs and feelings at the top of your priorities while you're on the phone." After the initial chit chat, the broker gets to the real reason for the call:

> __(First Name)__, let me say I don't have any investment recommendation to make today; although, I'm looking at some situations that really look promising. As you know (may know), in the stock market, timing is critical. Should an opportunity develop over the next few days or the next few weeks, you will be in a position to make an investment decision at that time--won't you?
>
> ANSWER: No problem.
>
> Great! One more thing __(First Name)__: To ensure that I'm looking in the correct area for you, let me say that most of my clients fall into one of two categories, either 8-15 thousand or 20-40 thousand dollars. Which of these two ranges suit your investment needs?

This second call is as misleading as the first. Contrary to the script, the broker is not searching the stock market for the right stock and the right time to buy it. He is simply setting up the prospect to invest as much as he can (and almost always more than he should) in some stock pulled out of the penny stock firm's inventory.

Call Three

One manual bluntly advises that to get the order (and only to get the order) is the purpose of the third call. Our clients report that during this call their brokers insist that a stock must be bought at once. Negative information is not given out and, in fact, the third call is the first time the prospect has even heard the name of the stock being recommended. One penny firm's script for the third call gives credence to reports of high pressure sales tactics based on minimal information:

> May I speak with M/M __________ please? M/M __________, this is ____________________ with [brokerage firm name deleted]. I told you I would call you back when something great came up. Well, it came up. Do you have a pencil or pen handy?
>
> M/M __________, before I take any of your time or mine, if what I have to tell you makes good business sense to you, is $_________ still well in range for you today?
>
> M/M _____________ the company I'm looking at right now (type of business they do, do not name company) ____. Tell me, how familiar are you with this type of industry? M/M ___________, there are three reasons why I feel this company is poised for profits. They are (1) __________, (2) _____________, and (3) ____________. These are the things you want to see for you investment dollar, aren't they?

The script book recommends telling the client that by buying 50,000 shares of stock he is availing himself of the "opportunity to take 50% short term gain . . . ." Evidently, since the script does not guarantee a 50% profit or even, strictly speaking, predict it, the firm feels that such comments are acceptable; they are, however, totally misleading.

Penny stock brokers also have developed cookbook approaches to deal with investor resistance. If a client says he does not have the money to invest, one script suggests alternative responses:

(1) When will you have the money?

(2) Where can you transfer the funds from?

(3) I'm not surprised, Mr. Prospect. Most sophisticated investors find themselves in non-liquid positions. But when the right opportunity comes along, they make themselves liquid. Am I right?

(4) Well, if an opportunity came along that I felt would give you a return of 30%, 40%, even 50% on your investment, would you be interested?

Honest brokers with legitimate firms do not urge clients to liquidate assets in order to buy investments with suggested returns of 30% to 50%. State and federal securities laws prohibit making predictions of profits without a reasonable basis. Likewise, industry rules concerning suitability may be violated by urging clients to liquidate assets in order to raise cash for speculative investments. On the other hand, penny stock brokers often use this kind of sales pitch to persuade clients to cash in certificates of deposit or take out home equity loans to "take advantage" of exciting investment opportunities yielding huge returns. The results of such practices can be tragic; life savings are liquidated, money is pulled from federally-insured deposits to be dissipated in penny stocks. Many times investors go into debt in order to buy deplorably poor quality investments.

If a prospect wants to think about the investment or asks if he can call back, the script shows the broker how to close the sale right away:

> (1) M/M-----, if you were convinced that this were the best opportunity on the horizon, the only thing to think about would be how large a position to take. Is that correct?
>
> (2) To procrastinate is the easy way out of everything that takes courage. I use that word because it does take courage to be a leader and to decide to take action. A wise man once said that more money has been lost through indecision than by a wrong decision. In analyzing your financial needs, it is clear that this investment could provide a tremendous return on your hard earned dollars. Thousands of other astute investors have trusted our advice. If I'm reading you right, and I think I am, I believe you are a leader and you're willing to trust me.

If the prospect wants to talk to a lawyer or accountant before investing, the broker tries to dissuade him:

> I think I can understand your desire to get another opinion. However, as one of my successful clients once told me, if he had been given good solid tax planning in the past, he wouldn't even need this investment. Few people realize that most accountants and attorneys are not tax specialists until it is too late and consequently, they end up paying too much in needless taxes. I'm offering you an alternative to what your accountant and attorney have been able to offer to you in the past. I believe you're ready to look to the future and do what you feel is the right thing to do.

Of course, the script books do not reveal all of the tricks of the trade. There are some sales pitches that penny stock firms know should not be put in writing. Sometimes - in fact with alarming frequency - investors are urged to buy a stock because there is a pending announcement of a merger, buy-out, or other favorable development which will increase the price of the stock dramatically. Most investors do not appreciate that when a broker describes an announcement "that's about to be made," he is purporting to have inside information. Most of the time, however, the purported "inside information" is fiction, but it is a form of fraud.

As a general proposition, the sales practices followed by penny firms are illegal, deceptive, and the grossest kind of abuse of the fiduciary duty owed to brokerage clients. They are also standard operating procedure.

Absence of Meaningful Written Information About Investments for Clients

From the first call to the closing of the sale, the brokerage usually avoids sending the client anything in writing about the stocks being recommended. At some penny stock firms there are policies against sending clients written materials concerning the stocks they are being urged to purchase. At one firm, the saying is "If you mail, you fail." This is because often disclosure documents filed with the SEC reveal that companies are financial basket cases. I have seen from such documents that many companies touted by penny stock brokers were: (1) insolvent or actually in bankruptcy; (2) subject to tax liens for unpaid federal withholding tax; (3) the subject of prior SEC enforcement actions or grand jury indictments; (4) run by people with absolutely no relevant experience in business.[1] Of course, these documents are not sent to penny stock clients.

Often the brokers who are selling penny stocks are glaringly ignorant about the companies whose shares are being sold. Many times, all that they know about the issuing company is what they have been told by their branch managers or in sales meetings. In some instances, brokers are actually discouraged from reading prospectuses, annual reports and similar information.

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[1] For example, the officers and directors of CDT Ventures, Inc., a blind pool company marketed by Blinder Robinson & Co., Inc., included a president who was a movie studio construction supervisor and a secretary/treasurer whose qualifications were listed as having been a construction office manager, labor foreman, and a back-up singer.

Penny stock firms sometimes do publish written "research reports" concerning the stocks that they peddle. Frequently, these research reports are a part of the effort to deceive investors since they misrepresent or omit material facts about the companies being traded. Often these reports are no more than "tout sheets" which omit negative information. Indeed, one can search in vain in these research reports for information concerning the operating history, earnings record, history of deficits, or meaningful economic forecasts for the particular company whose shares are being sold.[2]

It is a misrepresentation for many of these penny stock firms to suggest that they "research" the stocks they recommend. For example, according to United States District Court Judge R. F. Kelly, who was considering a class action brought against Blinder Robinson & Co., Inc., the firm's "research department" consisted of one person whose function was to "look at companies Blinder Robinson has underwritten from time to time, get information and send updates to salesmen, sometimes with a recommendation. . . The research department does no independent study of the issuer." (Hoxworth v. Blinder Robinson & Co., Inc. and Meyer Blinder, Civil Action No. 88-0285, decision dated May 23, 1989, Paragraphs 47-49). However, as the Court found, Blinder Robinson's salesmen were "instructed to tell customers that their recommendations are based upon reports from the 'research department.'"

"Spreads" in Penny Stocks

The most glaring misrepresentations and material omissions involved in the sale of penny stocks concern the so- called "spread." The "spread" is the difference between the bid price, which is what the penny stock firm will pay to purchase a particular stock, and the ask price, which is what it will charge the client. In the Thomason case we ultimately obtained discovery of Blinder Robinson's bid and ask quotations. These documents revealed that, for example, when the Thomasons followed a recommendation by their broker to buy Telephone Express shares on February 5, 1987 at $.0375 per share, the Blinder bid price on those shares was only $.0075. This means that had they sold their Telephone Express stock the same day as they bought it, they would have suffered a loss of 80% of their investment. Put another way, owing to the difference between the bid and the ask price, if the bid price did not go up by 500%, the Thomasons could not have broken even on their investment. On the average, the bid prices on the Blinder Robinson stocks in their portfolio had to go up 168% just for the Thomasons to break even.

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[2] Indeed, a research report by First Jersey Securities, Inc. recommended Medical Dynamics, Inc. as "an attractive investment" for investors "who can discern the hidden values in this highly inventive company . . . ." The research report fails to mention that the company had been in existence for 11 years but had never operated at a profit for a full fiscal year.

If the "spreads" inherent in penny stocks were known, few would purchase them. Brokerage firms should be required to reveal the amount of the "spread" in plain English terms on confirmation slips. For example, a confirmation slip could show that, due to the difference between the bid price and the ask price, each $1,000.00 invested was worth only $200.[3]

Under the current system in which "spreads" are not disclosed, penny stock brokers actually have a financial motivation to solicit investments with huge "spreads." The greater the "spread", the greater a firm's profit. The greater the firm's profit, the greater the commission paid to the salesman. Unfortunately, the larger the "spread," the smaller the likelihood that the investor will ever break even; even smaller is the chance of making a profit.

Misrepresentations Concerning Transaction Costs

Clients of penny stock firms are frequently deceived concerning the compensation paid to their stockbrokers. Bobby and Debra Thomason, for example, were told that Blinder brokers did not earn any commissions on purchases and sales of securities. In reality, the profits generated on the penny stocks which they bought and sold, and on most penny stocks sold by penny stock firms, are so huge as to shock the conscience. A "commission run" obtained in discovery from Blinder Robinson, revealed that when their broker purchased shares of Equitex, Inc. in the Thomason account for $7,637.50, the "gross commission" (compensation to the firm) was $812.50, of which the salesman was paid 50% or $406.25. When the Thomasons subsequently sold their Equitex stock for $5,525.00, the "gross commission" was $1,225.00, of which the salesman again received one-half.

In a case which we now have pending in NASD arbitration against a major penny stock firm, records obtained in discovery disclosed that firm profits on the penny stocks purchased in the account ranged from 10% to over 30%. Contrast these figures with the typical commissions charged by brokerage firms on New York Stock Exchange or American Stock Exchange transactions which seldom exceed 3% of the purchase or sale price. Unfortunately, current regulations governing confirmation slips tend to facilitate misrepresentations about broker compensation. As indicated by Exhibits "A" and "B", the purchase and sale confirmation slips sent by Blinder Robinson to Mr. and Mrs. Thomason did not show any amount paid as commissions, even though over two thousand dollars were paid in compensation to the firm, one-half of which was paid to the broker. Blinder Robinson and other penny stock firms can get away with this because of the technical distinction between selling stocks as a principal (i.e. selling out of one's own inventory) and selling on an agency basis. Profits on agency trades are called commissions; those on principal trades are called mark ups. Both represent transaction costs that clients should know about. Under current SEC rules, commissions on agency trades must be disclosed. Information about mark ups (and mark downs) on some kinds of principal trades must be disclosed, although not in the area of greatest abuse (i.e., pink sheet trades) Even when mark ups are disclosed, information is often provided in highly misleading ways.[4]

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[3] Similarly, the so-called monthly statements sent to clients by penny stock brokerage firms disclose which stocks are in a portfolio, but usually do not price these stocks. Thus, clients may not know for months how much money they have lost on their penny stock investments. A bill introduced in the current session of the Georgia Legislature requires account statements to show bid prices for securities held in the client's account.

Obviously, if a brokerage firm is charging the client 10%, 20%, 30% above the cost of a security, the customer has good reason to wonder what the security involved is really worth. If the brokerage firm is able to take a 30% profit on a stock sale, the stock is probably worth approximately 30% less than the client paid for it. Few penny stock clients are likely to see sufficient appreciation in the stocks they buy to cover the spread or to make up the outrageous charges being paid to their brokerage firms.

The "New Issue" Game

Contrary to what one might expect, some investors make money on stocks sold by penny stock firms. In fact, many investors do see large percentage returns on certain investments that they make with penny stock brokerages. The Thomasons, as is typical of clients whom we have represented, actually made money when they were "allowed" to purchase in the initial public offering ("IPO") of a stock underwritten by the penny stock brokerage. Some clients are given small amounts of IPO stock as a confidence-building measure to demonstrate to them that their penny stock broker can and will produce profits. Yet non-IPO stock (secondary market stock) typically makes up the overwhelming portion of client portfolios. Thus, clients may experience spectacular gains overnight on relatively small investments in IPO stocks, while the majority of their portfolio becomes virtually valueless.

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[4] While SEC Rule 10b-5 appears to call for disclosure of large commissions, since they are certainly a material fact relating to the value of the security being traded, brokerage firms often argue that once they have complied with the disclosure requirements of SEC Rule 10b-10 (governing the content of confirmation slips) they have disclosed as much as the law requires. See, Ettinger v. Merrill Lynch et al., 835 F.2d 1031 (3d Cir. 1987).

In an IPO sponsored by a penny stock firm, the penny brokerage is often the sole underwriter of a new issue for a particular company. Usually, the company being underwritten has nothing in particular to commend it to public investors. These are frequently companies which cannot obtain capital from legitimate investment banking firms or from banks. In many instances, including some now the subject of criminal investigations, the company being brought public is a "blind pool" or shell corporation, which consists of only a post office box, several nominee accounts and a bank account, which will be cleaned out as quickly as possible.

In a typical penny stock IPO, a first set of clients (the "A Group") is solicited to buy new issue stock and sometimes is even required to send in funds to buy their stock in advance of the registration date of the new stock offering. The "A Group" clients are generally told that only a small amount of IPO shares can be made available to them, due to the huge demand for new issue stock. "A Group" clients seldom hold their IPO stock for any appreciable amount of time. Most often they are called within a matter of days after their purchase and told that for one reason or another it is advisable to sell the shares. Often they are told that they can do so at substantial profits. Sometimes, as with the Thomasons, clients are told they _must_ sell their new issue stock. These clients are not told that at the same time that they are being urged to sell their IPO stock, the brokerage has set up a second set of customers, the "B Group," to buy that same stock at much higher prices than those at which the "A Group" was urged to sell.

In one instance which is currently the subject of class action litigation, it appears that a penny stock firm brought out units consisting of 100 shares of common stock and 50 warrants at $7.00 a unit in an initial public offering. On the same day as that stock was sold, the "A Group" customers were urged to sell units for $11.25, a profit of over 60%. However, these clients were not told that the brokerage firm was simultaneously selling the same units to other customers, the "B Group" at approximately _$20.00_ per unit. What rational client would sell his brokerage firm stock for $11.25 per unit if he knew that there were buyers ready to pay $20.00 for the same units? Even the investors who make profits by selling IPO stock were defrauded, since they are misled into selling their shares without being told that a much higher purchase price is available. In any event, it is relatively rare for IPO customers who make profits to keep them, because they are generally urged to reinvest their profits in secondary stock.

The IPO game facilitates cross-trading of stock (i.e. inducing one customer to sell a security at a relatively low price while, at the same time, inducing another customer to buy the same security from the salesman at a high price). This makes it possible to manipulate the price of stocks peddled by penny firms.

Market Manipulation of Penny Stocks

Reports in the media, accounts of SEC enforcement actions, and our firm's experiences in litigating penny stock issues suggest that market manipulation is common in the penny stock arena. Unlike exchange-listed securities which are frequently followed by many firms and analysts, the issuers of penny stocks are usually obscure corporations of no interest to legitimate brokerages and analysts. Thus, there is little information available about these companies and even less competition in setting prices for their shares.

In a typical case, a penny stock firm will either act as sole underwriter of a penny stock or, through means which are often illegal, acquire the majority of its free trading shares after the company has been brought public by others. Thus, the penny stock firm controls the supply of the shares of the company. The penny stock firm can then create demand by using brokers to whip up investor enthusiasm based upon misleading sales pitches. By controlling the supply of stock and misinforming the public to create investor demand , prices can be set at artificial levels.

Penny stock firms can also manipulate stock prices by buying and selling with their customers. In the previously cited example of the new issue stock which went from an IPO price of $7.00 to $11.25 to $20.00 within approximately two days, it is obvious that the sales force generated large numbers of buy and sell orders by telling one group of customers that it was time to sell back their new issue stock, while simultaneously telling another group that it was time to purchase those same units.

Penny stock market manipulation is highly orchestrated. There have been reports that prior to the opening day of trading of new issue stock, brokers were instructed to fill out order tickets for the initial sales of the stock to the "A Group" of customers, for the repurchase of those shares by the penny firm from the "A Group," and for the resale of the same shares to "B Group" customers. Reportedly, penny stock brokers are sometimes instructed to fill out the quantity and price of these transactions days in advance of the opening day of trading. If order tickets can be filled out in advance of the opening of new issue stock, it can only be because penny stock brokers are blessed with the ability to predict the future or, perhaps more plausibly, because they have rigged the market in advance.

Artificially high prices can be maintained by doing whatever is necessary to keep clients from selling out of stock positions. These tactics can include misleading clients about the value of their stock, brow-beating clients who want to sell out, and simply ignoring sell orders.

It is not uncommon for the pricing of penny stocks to be so irrational that in some instances clients are persuaded to buy warrants (i.e., the right to purchase stocks at a pre-set price) at prices which cannot be the product of an informed and competitive market. In one case involving First Jersey Securities, our client paid $0.75 per warrant for the right to purchase common stock at $1.00 per share. Common stock of the company was then trading at $1.00 per share. Had our client exercised his warrant to buy shares of common stock, it would have cost him his initial outlay of $0.75 for the warrant, plus $1.00 per share for the common, for a total price of $1.75.

There is other evidence of market manipulation of penny stocks. In many instances, the inference of market manipulation is drawn from evidence of spectacular increases in the price of obscure penny stocks even though there are no business developments that would support such an increase. In one case we arbitrated, the evidence showed that the promoters of a blind pool company purchased shares for $0.001 per share, sold those same shares for $0.01 right away to two men who in turn sold their shares to a major penny stock firm for $.015 per share. The penny firm then made a 300% profit by selling the same shares to its customers at $.045 per share. The company was a blind pool Its management consisted of a bookkeeper, her twenty year old [illegible], and her twenty-three year old daughter. There were no business developments of any kind during the period of the spectacular price increase, but there was an enthusiastic sales force earning large commissions hard at work on the investing public.

In a case which we are litigating, the officer of a publicly traded corporation admitted that he and other promoters of an insolvent shell corporation entered into an agreement under which market makers who agreed to list the company's shares in the "pink sheets" would be issued over two million shares of stock (hidden in nominee accounts) at no cost to them. A review of the "pink sheets" indicated that the stock was, in fact, listed at over $5.00 per share for the better part of a year, even though there was no trading in the company's shares, at any price, until our clients were persuaded by a penny stock firm to purchase several hundred thousand dollars worth. Through discovery, we learned that four-fifths of the purchase price for these shares was parcelled out as "finder's fees" to various individuals (one of whom has been recently jailed for stock fraud) involved in setting up the sale. The stockbroker who set up the transaction got an undisclosed finder's fee of approximately $65,000. Central to the plot was the apparent cooperation of market makers who were apparently willing to plant misleading bid and ask quotations in the "pink sheets" to create the appearance of an active trading market.

Redressing Investor Grievances

Most of the conduct which I have described as being typical of penny stock firms constitutes outright violations of state and federal securities laws. The problem becomes how defrauded investors can best utilize those laws to recoup their losses.

Most penny stock firms require clients to sign "customer agreements" which contain clauses requiring arbitration of disputes with the firm or its employees. As a result of recent Supreme Court decisions, these clauses are generally enforceable, even though they are almost never the product of negotiation, but are instead mere boiler-plate in contracts of adhesion. Unlike major brokerage firms, which are generally members of several exchanges and allow arbitration before various forums such as the New York Stock Exchange, American Stock Exchange, or the National Association of Securities Dealers, Inc. ("NASD"), most penny stock brokerage firms are only members of the NASD, so that is the sole forum in which investor claims can be heard.

In general, I believe that the arbitration process is fundamentally fair to the investor. I do not believe there is any inherent bias in the process which preordains defeat, or minimal victory, for investors. In my experience, arbitrators selected by the self-regulatory organizations ("SRO's") try to be fair and frequently reject legalistic arguments which could result in dismissal on technical grounds of a complaint brought in state or federal court. Furthermore, arbitrators often afford great weight in their deliberations to the rules of fair practice of the SRO's. These rules govern matters such as client suitability, requirements that there be a "reasonable basis" for recommendations, and diligence in supervising accounts. These rules protect investors and impose high standards of business ethics in dealing with the public. Although these rules may not be afforded the weight of law in court (but are often recognized as evidence of the standard of care in the brokerage profession), they are, in effect, a substantive body of law which arbitrators can and do apply in deciding cases. The use of industry standards by arbitrators poses a distinct advantage for investors who must arbitrate their disputes.

It has not been our experience that arbitrators chosen from the securities industry display any particular bias in favor of brokerage firms. To the contrary, many industry arbitrators are distinguished individuals who are willing to sacrifice their time in order to do their best to uphold the best standards of their profession. Investors are often surprised to learn that the industry arbitrator is the one who may be their best advocate in the arbitration process.

There are, however, serious problems with the current arbitration process. There is legitimate room for debate as to whether investors should be required to submit their disputes to arbitration when the arbitration agreements which they sign are not the subject of free negotiations between parties of equal bargaining strength. It also appears to be unfair that the clients of penny stock firms may be limited to arbitration in the NASD, whereas clients of larger firms have additional options.

Beyond the issue of freedom of choice in selecting arbitration, there is certainly room for improvement in the arbitration process. The Securities and Exchange Commission has recently taken an active role in overseeing the arbitration rules of the various SRO's and has facilitated useful reforms through formal rule-making and informal "jaw-boning." Yet much improvement is still needed. Most notably, there is a need to involve arbitrators in case management. Currently, arbitration panels are usually not appointed until a few weeks before the scheduled hearing of the case, which may be a year or more after a case is filed. Thus, in many cases handled by my firm, we have served discovery requests upon brokerage firms only to have them totally ignored, notwithstanding rules which require responses within thirty days. By the time an arbitrator is appointed to hear the case and resolve discovery controversies, months may have passed without the Claimant having access to documents which are often critical to the case. In fact, the more critical the document, the less likely that it will be seen until the eve of the hearing, if at all. If at least one arbitrator were appointed as soon as the pleadings were closed in a case, discovery controversies could be brought to a prompt resolution, to the great advantage of the investing public. Under current circumstances, many brokerage firms (and not only penny firms) ignore their obligations under the discovery rules because they do not perceive any serious sanctions for such abuse.

Another problem which plagues the arbitration process is excessive secrecy. There is a myth that arbitration is secret, although there is no statutory basis for such secrecy. The public, the press, and even other investors with claims similar to those being heard, are barred from the arbitration hearing room. They would not be barred from the courtroom, and it is difficult to see who, other than brokerage firms, benefits from this secrecy. Indeed, while recent amendments to arbitration rules now allow for the publication of arbitration awards, these documents seldom do more than present the outcome of a case without giving any meaningful information that might aid other investors with similar problems. While published court decisions generally include the names of counsel for the parties, arbitration decisions do not list counsel. This makes it difficult for a party to locate others who may have successfully arbitrated similar issues with particular firms.

There is no justification for continuing to tolerate secrecy in the arbitration process. Issues of great public interest involving securities fraud and racketeering are now being decided in arbitration. Secret hearings deny the public information about brokerage firm misconduct which may be directly relevant to thousands of investors.

The arbitration process is also unequipped to handle class action litigation. Class action litigation is an extremely effective way to handle claims of thousands of investors who may have lost relatively small sums of money as a result of patterns of deceptive practices by a particular firm. Indeed, many penny stock investors lose small sums of money, such as $5,000.00 or less. For many people, $5,000.00 is quite a bit of money. It may, in fact, be every bit of their savings. Yet in today's legal environment it is almost impossible for an individual who has lost "only" $5,000.00 to find a lawyer, bring a case, conduct discovery, and pursue it to recovery. If a penny stock firm has a policy against settling cases, particulary where the complaints go to the firm's overall manner of doing business, there is virtually no way that such defrauded investors will be able to afford to arbitrate their cases. Class action litigation affords these investors a chance of recovery.

Class action cases have been brought against several of the major penny stock brokerage firms. If courts give investors an opportunity to "opt out" of class action claims (perhaps because they believe they can obtain better recoveries in their own cases), those with smaller claims can still participate in the class and recover something, even though the relatively small size of their own claim would have made an individual claim unfeasible.

Recommendations

1.

Penny stock fraud must be recognized as a major destructive force in the American economy. Money is drawn from savings accounts and legitimate forms of investment only to be squandered on worthless investments. In order to protect the investing public and avoid the needless dissipation of useful capital, enforcement against penny stock fraud should continue to be a major civil and criminal priority of the SEC and the Department of Justice. More criminal cases should be brought and penny stock con-artists should have reason to fear that their conduct may result in imprisonment for lengthy terms. To the maximum extent possible those who have defrauded the investing public should be barred from the investment business.

2.

Regulations should be promulgated by the SEC requiring disclosure in "plain English" of spreads and commissions on stocks.

3.

States should be encouraged to utilize their own "Blue Sky Laws" to develop new and innovative techniques for dealing with penny stock fraud.

4.

The civil remedies under the federal Racketeer Influenced and Corrupt Organizations ("RICO") Act should be preserved. Unfortunately, the Securities Act of 1933 and the Securities Exchange Act of 1934 do not provide for awards of punitive damages or attorney's fees for investors who prove claims of brokerage house fraud. If the only sanction for violating securities fraud laws is having to repay out-of-pocket damages, stock fraud will be low-risk, high-return larceny. Under the federal RICO Act, patterns of mail, wire, and securities fraud which characterize the way many penny stock firms do business can form the basis for recovery of actual losses, treble damages, and attorney's fees. If investors can successfully prove a case of racketeering, treble damages and attorney's fees ought to be allowed and will possibly serve as a deterrent to future misconduct.

5.

The SEC should be encouraged to continue careful monitoring of the arbitration procedures of the various self-regulatory organizations. However, surveys ought to be done to determine whether the arbitration process is coping with the deluge of cases now imposed upon it.

6.

Federal legislation is advisable to open up the arbitration process so that the public can know as much about cases in arbitration as it would about cases in litigation. If the self-regulatory organizations do not voluntarily open their pleadings and hearings to press and public scrutiny, specific amendments ought to be made either to the Securities Exchange Act of 1934 or to the United States Arbitration Act.

7.

The United States Arbitration Act should be amended to provide that the right of parties to maintain class action litigation pursuant to Rule 23 of the Federal Rules of Civil Procedure shall not be impaired by enforcement of arbitration agreements.

8.

The SEC should carefully monitor the phenomenon of brokerage firms (and not only penny stock firms) soliciting clients to invest in proprietary products sold out of the brokerage's own inventory. Unfortunately, the same economic concerns which lead penny brokers to recommend the stocks they sell as principal over less risky investments, are motivating NYSE and AMEX firms to create and sell securities out of their own inventories. These products are frequently inferior to quality stocks and bonds already being traded, but can generate more profits for the brokerage.

9.

Finally, the SEC should be encouraged to continue and expand its campaign of public education concerning penny stock abuse.

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SEE REVERSE SIDE FOR SYMBOL EXPLANATION

				CODES						
SYMBOL	ACCOUNT NO.	T	TRANS NO.	[illegible]	CAP	[illegible]	TRADE DATE	SETTLEMENT DATE	OFC	RR
EQTX	77382791	1	92860	0	6	2	08/20/87	08/27/87	03C	1544 M

BOBBY L. THOMASON AND
DEBRA J. THOMASON JT/WROS
1613 MELODY LANE
ELBERTON, GA 30635

America's Future
INVEST IN IT!

	QUANTITY	CUSIP NUMBER	SECURITY DESCRIPTION	COUPON/MATURITY
YOU BOT	32500	294592100	EQUITEX INC	

PRICE	PRINCIPAL	COMMISSION	STATE TAX/INTEREST	SEC	[illegible]	MISC.	NET AMOUNT
.235	7,637.50					10.00	7,647.50

MARKUP 528.12 RPT PRICE 7/32

CONFIRMATION

260-86-5853
DETACH HERE

The Blinder Building 6455 South Yosemite Englewood, Colorado 80111
(303) 773-6200 CO (800) 332-5646 NATL (800) 525-7678 TELEX 216180

Blinder, Robinson & Co., Inc.
INVESTMENT BANKERS
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SEE REVERSE SIDE FOR SYMBOL EXPLANATION

				CODES						
SYMBOL	ACCOUNT NO.	T	TRANS NO.	[illegible]	CAP	[illegible]	TRADE DATE	SETTLEMENT DATE	OFC	RR
EQTX	77382791	1	60204	0	6	42	02/04/88	02/11/88	03C	1544

BOBBY L. THOMASON AND
DEBRA J. THOMASON JT/WROS
1613 MELODY LANE
ELBERTON, GA 30635

America's Future
INVEST IN IT!

	QUANTITY	CUSIP NUMBER	SECURITY DESCRIPTION	COUPON/MATURITY
YOU SLD	32500	294592100	EQUITEX INC	

ENTRY DATE 02/08/88

PRICE	PRINCIPAL	COMMISSION	STATE TAX/INTEREST	SEC	[illegible]	MISC.	NET AMOUNT
.17	5,525.00					10.00	5,515.00

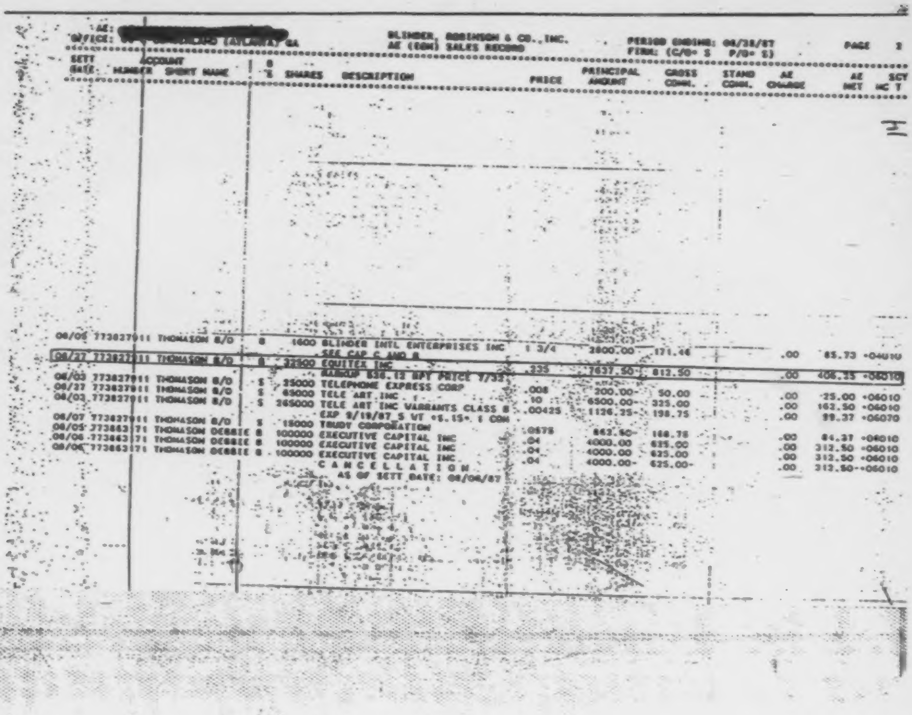
MARKDOWN 568.75 RPT PRICE 3/16

CONFIRMATION

260-86-5853
DETACH HERE

EXHIBIT A

Confirmation Slips



AE:
OFFICE: [redacted] GA

BLINDER, ROBINSON & CO.,INC.
AE (EOM) SALES RECORD

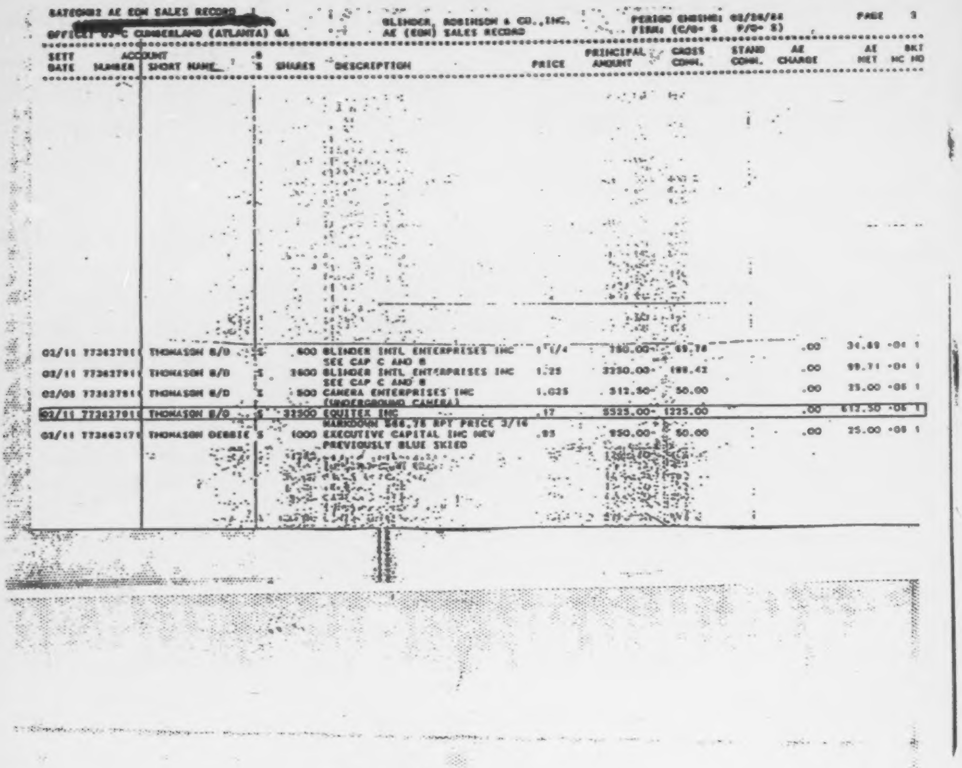
PERIOD ENDING: 08/28/87
FIRM: (C/O= S P/O= S)

PAGE 2

SETT DATE	ACCOUNT NUMBER	SHORT NAME	B S	SHARES	DESCRIPTION	PRICE	PRINCIPAL AMOUNT	GROSS COMM.	STAND COMM.	AE CHARGE	AE NET	SCY AC T
08/06	773827911	THOMASON B/O	B	1600	BLINDER INTL ENTERPRISES INC SEE CAP C AND B	1 3/4	2800.00	171.46		.00	85.73	+04010
08/27	773827911	THOMASON B/O	B	32500	EQUITEX INC MARKUP $38.12 BPT PRICE 7/32	.235	7637.50	812.50		.00	406.25	+06010
08/03	773827911	THOMASON B/O	S	25000	TELEPHONE EXPRESS CORP	.008	200.00-	50.00		.00	25.00	+06010
08/27	773827911	THOMASON B/O	S	65000	TELE ART INC	.10	6500.00-	325.00		.00	162.50	+06010
08/03	773827911	THOMASON B/O	S	265000	TELE ART INC WARRANTS CLASS B EXP 9/19/87 5 WT +5.15+ 1 COM	.00425	1126.25-	198.75		.00	99.37	+06070
08/07	773827911	THOMASON B/O	S	15000	TRUDY CORPORATION	.0575	862.50-	168.75		.00	84.37	+06010
08/05	773863171	THOMASON DEBBIE	B	100000	EXECUTIVE CAPITAL INC	.04	4000.00	625.00		.00	312.50	+06010
08/06	773863171	THOMASON DEBBIE	B	100000	EXECUTIVE CAPITAL INC	.04	4000.00	625.00		.00	312.50	+06010
08/06	773863171	THOMASON DEBBIE	B	100000	EXECUTIVE CAPITAL INC CANCELLATION AS OF SETT DATE: 08/06/87	.04	4000.00-	625.00-		.00	312.50-	+06010

EXHIBIT B-1

Firm Commission Records



BATCH082 AE EOM SALES RECORD 1
[redacted]
OFFICE: 03-C CUMBERLAND (ATLANTA) GA

BLINDER, ROBINSON & CO., INC.
AE (EOM) SALES RECORD

PERIOD ENDING: 02/26/84
FIRM: (C/O= S P/O= S)

PAGE 3

SETT DATE	ACCOUNT NUMBER	SHORT NAME	B S	SHARES	DESCRIPTION	PRICE	PRINCIPAL AMOUNT	GROSS COMM.	STAND COMM.	AE CHARGE	AE NET	BKT NC NO
02/11	77362791	THOMASON B/D	S	600	BLINDER INTL ENTERPRISES INC SEE CAP C AND B	1 1/4	750.00-	69.78		.00	34.89	-04 1
02/11	77362791	THOMASON B/D	S	2600	BLINDER INTL ENTERPRISES INC SEE CAP C AND B	1.25	3250.00-	199.42		.00	99.71	-04 1
02/05	77362791	THOMASON B/D	S	500	CAMERA ENTERPRISES INC (UNDERGROUND CAMERA)	1.025	512.50-	50.00		.00	25.00	-05 1
02/11	77362791	THOMASON B/D	S	32500	EQUITEX INC MARKDOWN 566.76 RPT PRICE 3/16	.17	5525.00-	1225.00		.00	612.50	-05 1
02/11	77366317	THOMASON DEBBIE	S	1000	EXECUTIVE CAPITAL INC NEW PREVIOUSLY BLUE SKIED	.95	950.00-	50.00		.00	25.00	-08 1

EXHIBIT B-2

Firm Commission Records

Senator BRYAN. Thank you very much, Mr. Smiley. I will have a few questions for you, and for Mr. Bernstein, who also has an extensive background and who has written on the subject.

Good morning, glad to have you with us.

STATEMENT OF HARTLEY T. BERNSTEIN, PARTNER, BRANDEIS & BERNSTEIN, NEW YORK, NY

Mr. BERNSTEIN. Good morning, Mr. Chairman.

My name is Hartley Bernstein. I practice in New York with the law firm of Brandeis & Bernstein.

In recent years, my practice has been focused very much on the problems that arise between brokers and their customers. Unfortunately, it seems to be a problem that has grown, and continues to grow with alarming proportions.

The example of Mr. and Mrs. Thomason is regrettably all too typical of what appears to have occured around the country, and which cuts strongly across geographic lines, age groups, income groups, and levels of sophistication.

The abuses and excesses of penny stock brokers which have been discussed today are well documented. But I think it is important not to lose sight that these same abuses go on and are carried on not only by the penny stock brokers, but by brokers who are employed by the so-called reputable, larger, national brokerage firms as well.

And I think that, were you to examine the records of the NASD and the New York Stock Exchange, and the number of cases that are filed on behalf of customers, you would find that the vast proportion of cases are filed not against the penny stock brokers, but against these larger national firms which employ so many brokers and have so many significant problems in actually supervising those people.

Regrettably, even the best and most reputable of firms have not erected an effective line of defense against employing individuals who subject their customers to these abuses. I think that is something that has to be kept in mind.

The impact of these abuses falls on both the investors and on the brokerage community. Investors, because they really suffer in most cases what is really a life-altering loss—to lose everything, to lose almost everything, is as great a penalty as one can possibly pay. And the ability to recover those losses is so scarce and so scant, as I will discuss and as I think has already been discussed, it is so remote, particularly where the firms are vanishing from the face of the Earth, that this life-altering situation is something that needs to be addressed.

True, those people who engage in these abuses need to be dealt with in a criminal context. The firms need to be dealt with in an injunctive context. What must be preeminent in our thoughts however has got to be some mechanism to make those people whole who have suffered this tremendous loss.

The abusers will go on and defend themselves. The agencies will go on and prosecute them. And the people who have suffered the losses, unfortunately, are all too often left to their own devices. The industry suffers too, because wherever its integrity is compromised in this way, confidence in the industry is shaken.

The specific improprieties fall into several categories, as I said, both in the penny stock situation and in other firms. Probably the principal one is the area of unsuitability, where individuals, regardless of who they are, find themselves in investments which are just too speculative for their needs, their objectives, and what they can afford.

In other instances, they are given misinformation, as we have heard in the penny stock and other situations, about companies, false information about what those companies are doing, what their prospects are, what their financial standing is.

In all of these situations, customers suffer, because there are unauthorized trades on their accounts as well. A smaller brokerage firm must suddenly call up and say, "We purchased this for your account. It is a new issue. Don't worry, it is terrific for you." And the next day, it vanishes from the account.

In a larger situation, unauthorized trading can go on every day in the same way. It can rise to proportions where accounts are churned. It can rise to proportions where, in a day or a week or a month, a life's savings are depleted totally.

The penny stock abuses can sometimes be easily defined, because, as is often the instance, they involve new issues, they involve companies with little assets, no prospects, no past, and no future. Not every stock which is a penny stock is in a company which is insubstantial. Many of these companies hope to be substantial, and many of these companies have turned to this method of financing, in an effort to take advantage of the ability to raise money and to get started.

They find themselves victimized by a process utilized by boiler rooms, where the manipulation of the stock bears no relationship to the business itself. And they become dependent upon the one or two market makers who will make the market in that stock.

A problem then arises for the company when those market makers disappear from the business, and suddenly there is no one left to make a market in that stock. And a company which had some prospects and some hopes suddenly finds that there is no one to market its securities.

It has happened recently to securities in which J.T. Moran made a market, or firm, which recently disappeared. It happens whenever an OTC brokerage firm goes out of business. Unfortunately, most smaller companies are concentrated in one or two brokerage firms. When they cease to exist, the impact on the company and the corresponding impact on the stockholder is dramatic.

The response to these problems has got to be in the areas of relief that are available. And those areas of relief have got to be made credible, they have to wield authority. The present recourse is almost singular. Due to the Supreme Court decisions, investors are constrained to arbitrate virtually all their claims. There is nothing inherently unfair about the system of arbitration, and indeed customers do get fair results in arbitration. But it is quite clear that the system, as it exists today, needs tremendous refinement.

I would applaud what Mr. Wilson of the NASD said earlier, because I think it is true that the arbitration system needs a single arbitration mechanism, and not this disparate mechanism that is run by various self-regulatory organizations.

I join with him in his thought that that mechanism should be a neutral mechanism. Because despite their best intentions, the self-regulatory agencies are the creations of the brokerage firms, the creations of the brokerage industry. Those firms are its members. Investors are not its members. And in perception and in practice, the need to move to a neutral system which will bring into play what has been learned by these self-regulatory agencies, and enhance it and refine it, I think is imperative.

It is important to enhance and to refine the method of selecting arbitrators, because today that method is at best esoteric to the investor, and at worst it is perceived as an industry-biased selection process. An investor who wants to have an arbitration hearing is told by the self-regulatory agency that it will have three arbitrators, and is told who those arbitrators will be.

Historically, agencies like the American Arbitration Association have given both sides the opportunity to select from a list of arbitrators, to rate those arbitrators. While that may not be the most fair, or always fair, method, it is certainly better than the system that exists now. It certainly gives both sides input which they presently lack.

I think a move in that direction is imperative. And a move has got to be made which expands that list of arbitrators to include not just professionals, not just lawyers, not just brokers, but investors as well. A comprehensive list of investors who can sit on arbitration panels needs to be developed. And I think that the mechanism for developing that list already exists, right in the customer lists of the broker-dealers.

That can serve at least as an initial resource for developing and expanding the pool of arbitrators, and creating what will be a neutral and uniform system. At the very least, it would provide a further demonstration of the efforts of self-regulators to balance the system, which is unfortunately perceived as inherently biased and which in practice appears to be somewhat biased.

There is one other area which is subject to considerable debate, and is still before the courts. That is, providing a mechanism whereby investors have a choice to arbitrate or not to arbitrate. The Supreme Court is now going to be considering a Massachusetts statute which would afford investors the option to either go to court or to go to arbitration.

Even if that option were adopted, I think we would find that many people would go to arbitration, because it is inexpensive, it is efficient, it is expeditious. But the existence of that option would provide I think just another deterrent which would encourage brokers to act in the most proper way possible, and would discourage these abuses which this committee is addressing.

Thank you.

[The complete statement of Hartley Bernstein follows:]

SUBMITTED BY HARTLEY T. BERNSTEIN IN CONNECTION WITH TESTIMONY BEFORE THE UNITED STATES SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, SUBCOMMITTEE ON SECURITIES ON FEBRUARY 8, 1990

My name is Hartley Bernstein. I am a partner with the New York law firm of Brandeis, Bernstein. In recent years my practice has focused principally on disputes between securities brokerage firms and their customers, both in the courts and in arbitration.

The abuses and excesses of the brokerage industry cut across economic lines, age groups and geographic areas. They range from the subtleties of unsuitability to blatant fraud, manipulation and churning. And they are perpetrated by some of the most ingratiating, intoxicating and reassuring salespersons since Elmer Gantry plied his trade.

Not all customer claims are meritorious. And no customer should escape responsibility for his or her own conduct and neglect. The excesses of the brokerage industry exist, in part, because of the predeposition of investors to believe in the promised "pot of gold". On the other hand, brokers should be aware that their misconduct will not go unpunished. Those brokers who engage in such improper practices may indeed comprise a small minority of the industry, but their actions have an impact far in excess of their numbers. Improper brokerage activities do not affect only the large investor. In my law practice I regularly represent investors whose losses range from only a few thousand dollars to those who have suffered losses of several hundred thousand and even millions of dollars. Significantly, while the numbers may vary widely, the practices which cause those losses are remarkably similar. While suitability standards differ for large and small investors, each of those standards can be subject to abuse and readily compromised. One recent client, over 60 years of age, watched his life savings of several hundred thousand dollars disappear as a result of the index option trading his broker insisted would be of no appreciable risk. In that case the broker had cultivated the customer over a period of years, gradually convincing the customer that the broker considered him a "father" figure and in turn assuring the customer that the broker would never permit "Dad" to risk loss of his assets. Unfortunately, as we later learned, the broker's extended family was not limited to "Dad"; he had made similar endearing relationships with other customers and our client's savings soon expired with his options.

No less disturbing is the all too typical case of a Florida widow whose income was less than $30,000 and whose broker assured her that no more than $10,000 of her $100,000 life savings would be exposed to his novel option strategy. When market fluctuations soon proved his strategy wrong, and margin calls cost her most of her remaining savings, the broker was quick to disclaim responsibility. Instead, he insisted that the customer (who had never traded in options before) had a full understanding of the most complex options strategies and could not possibly have failed to understand the risks. After all, she had telephoned his office every day and, according to his notes, he had discussed with her the transactions which he intended to pursue. Regrettably, to her ear he spoke a foreign language.

Risks, are often not fully appreciated by investors; particularly where they are systematically minimized by their brokers. In truth, the customers who I have just referred to, with limited assets and negligible future earnings power, never should have become involved in trading options or even maintaining margin accounts. Their cases, however, are not unique. Brokerage firms approve margin and option agreements on an almost pro forma basis. Despite its obligation to "know the customer", the brokerage firm operates principally on unverified and superficial information which it receives principally through its salespersons. A more thorough verification system would certainly provide one mechanism for screening suitability on a more accurate basis.

While customers may range from young businessmen and women to retirees, the techniques of abuse fall into several well defined categories, principally consisting of unsuitability, unauthorized trading, market manipulation, churning, fraud and breach of fiduciary duty. Most prevalent are unsuitable investments. Investments are unsuitable when they are inappropriate for an investor based upon his or her assets, income, experience and objectives. Based upon this sliding scale, there are unsuitable investments for everyone -- and remarkably there are unscrupulous salespersons who will find them. In one instance, I represented a widow whose assets consisted solely of her husband's life insurance proceeds, who soon found herself trading on margin with her broker's encouragement. One morning, the broker interrupted the client's weekly bowling game to tell her that the account had been wiped out and she had no choice but to liquidate.

On another occasion, a middle-aged couple living on a family trust was persuaded by their new broker to invest those trust funds in commodities, index options and futures. The trusts had previously been invested conservatively through a federally insured bank. Once the transition was made the trust funds disappeared in short order.

In yet another instance a couple living on the husband's military salary advised their broker that they would need to preserve their assets to pay for the care of a close relative suffering from Alzheimers disease. Rather than follow these directions and seek safe, well-protected investments, the broker quickly suggested a series of highly speculative securities, and those assets soon diminished.

Options trading, margin trading, speculative securities-- all high risk instruments which are not suitable for most investors. Customers on fixed incomes and others whose assets are not easily replenished, can never be suitable candidates for excessive risk. Yet brokers regularly minimize risk -- and the transition from a conservative covered call, to a naked put, to an index option can be subtle and disastrous. One customer who had achieved a level of comfort selling options on stock which he owned, soon found himself involved in far more risky options trading which he was assured carried no greater risks. This, of course, soon proved untrue.

Our files are filled with complaints from customers who first visit a brokerage firm for one purpose and soon find themselves following a distinctly different course. In each instance, they rely upon the expert -- a fact too often lost upon the arbitrators who ultimately hear their complaints. All too often those arbitrators ask how anyone could be so foolish as to believe the blandishments and representations of such salesmen. Far too frequently, these same arbitrators look skeptically upon the more naive and inexperienced investors, suggesting that no one could possibly fail to understand the risks involved and the possibility of calamity. Certainly the arbitrators would have seen disaster around the corner. Regrettably, these victims are not blessed with the same degree of wisdom and sophistication possessed by the typical arbitrator. Yet far too little weight is afforded to the discrepancy in knowledge between the trained salesmen and the less experienced but trusting customer. Arbitrators who fail to note that distinction -- and in my experience there have been many -- have lost sight of the purpose of any remedial system, to protect those who are not able to protect themselves and to create a balanced even playing field. There is no room for the view that a customer is not entitled to relief if he or she is too foolish, too inexperienced or just too unknowledgeable to avoid the wrongdoer in the first place. Where the customer suffers from these limitations, the obligation is even greater for the broker to know the limitations of that customer, to recommend trades within a suitable framework and to avoid excess.

Misconduct is not confined to any category of brokerage firm. Large national firms and small penny-stock houses each employ their share of wrongdoers. Suitability cuts across all lines. Unauthorized trading is generally more isolated. The broker who telephones to tell his customer that he has just purchased or sold shares for that customer's account. The trade may not have been authorized, but most frequently the customer does not know that the trade can or should be disavowed. Instead, the customer just accepts the fail accompli. Frequently, such customers later state that they assumed the broker knew what he was doing. Unauthorized trading of this nature occurs every day -- investors accept trades they never knew and did not want -- and they often do so gratefully but to their ultimate regret. Years later, with their savings depleted, those same customers find that it is far too late to complain of unauthorized conduct. When they do so the response is predictable -- if the trade was unauthorized, the firm points out, why did you not complain at the time. There is no good answer to that question.

Abuse of discretion also forms the basis for many investor complaints. The customer who affords his broker discretion must understand that he or she surrenders day to day control of the account. While discretion is not inherently corrupt, it is certainly corruptible and provides a framework for excessive transactions entered for the sole purpose of generating commissions. The practice, known as churning, provides the customer with constant activity, few profits, and considerable commissions. Customers would be well advised to avoid discretionary accounts. For the most part, they serve no positive purpose and many brokers refuse to even maintain them.

Misrepresentations by brokers take many forms. Statements that a broker is intimate with a company, has met with company officials or has obtained infallible information are most flagrant areas of misinformation. Reports of non-existent "imminent" developments are one other. In one recent case, a broker convinced his customer to accumulate a position in one security by assuring that customer that the broker and his family were investing in the same company. In truth, neither the broker nor his family owned a single share of the stock.

Increasing focus has been devoted to the improper sales practices of some penny stock houses. In the past, customers have been recipients of "cold calls", seeking their purchase of little known companies valued at a few cents and with no significant past or foreseeable future. Penny stocks and other new issues are not themselves objectionable; they become a problem only when the investors are not made fully aware of the risks involved, the brokerage refuses to let that customer liquidate a position in the securities, or the securities are merely being moved from one customer's account to another to manipulate prices. I can think of at least three cases where our clients were prevented from selling securities, but never recovered their losses because such firms disappeared before an arbitration hearing could be concluded. And when such firms do disappear, they often take with them many of the companies in whose stock they are the principal market maker.

Faced with these complaints, many of the smallest brokerage firms fade from sight while the largest react predictably. In general, almost every written complaint to a large brokerage firm receives in response a letter from the legal or compliance department advising the customer that the matter has been reviewed, the broker has been interviewed, and there is no merit to the customer's claim. This self-serving letter generally goes on to say that while the firm regrets any losses suffered by the customer, the customer must realize that the purchase and sale of securities can result in losses and that such losses were not the responsibility of the firm or broker.

Faced with this generally frustrating response, customers have few recourses. Perhaps their best alternative is to take self-protective steps to avoid the possibility of misconduct by the broker. Customers should adopt the habit of reading brokerage agreements before signing them, questioning provisions in those agreements, ascertaining that the information placed upon their new account forms is accurate and complaining as soon as they become aware of improprieties.

While these rules sound quite simple, their implementation is far more difficult. Customers regularly tell us that they have been asked by brokers to sign new account agreements even though the income and asset information is incorrect, because the brokers insist that their office managers will not open the account with less sufficient information.

Many customers contribute to their own problems by their failure to review confirmations and monthly statements. Those who do read the monthly statements are often limited by their inability to understand the documents. Compounding the problem, many monthly statements contain trade "corrections", receipts, deliveries and other entries which render them virtually unintelligible.

If the customer is to be assisted in his or her efforts to protect against the possibility of wrongdoing, he or she must first have access to readily understandable information. It is imperative, therefore, for the industry to adopt a uniform monthly account statement. The creation of a uniform monthly statement, without superfluous "entries", would at least enable every customer to understand and analyze the transactions in his or her account.

A move toward uniformity should also include the adoption of uniform customer agreements, printed in visible type and drafted in plain English.

Armed with clear agreements, afforded ample opportunity to review those documents before they are signed, and exercising caution before affording anyone authority to purchase or sell securities for their account, the customer has the ability to protect himself from brokerage abuses. Where those abuses nevertheless occur, the customer at present has little recourse but to pursue the existing arbitration process.

The Arbitration System

The arbitration process has become a battleground for small investors and representatives of the securities industry; in the wake of recent Supreme Court decisions representatives of investors have searched, thus far in vain, for an alternative to industry mandated arbitration of disputes. The rights of investors dictate that this battle be waged on two fronts if the public is to be protected in its dealings with the investment community and afforded protected under the legal system. If, as it now appears, arbitration is here to stay, the existing system is in need of far reaching refinements. At the same time, efforts to permit investors an alternative to arbitration deserve heightened attention, both from this Congress and the Courts.

In its decision in MacMahon v. Shearson American Express, the Supreme Court continued its seemingly singleminded determination to enforce the viability of arbitration agreements between investment customers and brokerage houses. This decision, following closely on the heels of Byrd v. Dean Witter

Reynolds, Inc. forms the basis for today's state of the system. While it is clear that the Court's determinations reflect a fondness for the arbitration process as an alternative to court-based litigation, they do little to respond to the actualities of the marketplace. Prior to MacMahon and Byrd, aggrieved customers possessed access, in certain instances, to the judicial systems of fifty states, the federal courts and the arbitration tribunals of the self-regulatory organizations. The existence of that broad spectrum in itself constituted a system of checks and balances; these various co-existing administrative and judicial agencies shepherded cases through the process, each possessed its own mechanism for pre-trial discovery, and ultimately, decisions could rest in the hands of judges, jurors or arbitrators.

The very existence of these alternative dispositions, and the varying degrees of concern which they instilled in the brokerage industry, served as a constant warning to those brokers who might be inclined to abuse their relationships with customers. The potential churner, the incipient unauthorized trader would likely be far more reluctant to pursue such unlawful activities when faced with the possibility of a lengthy court proceeding, a jury trial and punitive damages. That same potential wrongdoer can take comfort in the knowledge that he or she will now instead face a panel of three arbitrators (which includes one securities industry member) under the sponsorship of an industry self-regulated organization.

While arbitration can certainly be fair, there is no question that the public perception, as often borne out by the results and reinforced by public commentary, is one of an industry-based forum where most customer claims are given little credence, little opportunity for pre-hearing discovery is available, the panel of arbitrators is inherently jaded and the customer can hope for, at best, recovery of a small percentage of his or her losses. Fear of penalty, always a principal deterrent to the potential wrongdoer, has been virtually removed from an investment system which possesses the potential for unbridled abuses.

As an attorney who has represented customers in such disputes both before and after MacMahon, the value of alternative methods of disposition is inescapable. Truly aggrieved customers who might otherwise pursue their claims in court frequently advise me that they will drop their complaint rather than rely upon the arbitration system. This crisis in confidence demands immediate reform. The self-regulatory agencies have long maintained arbitration procedures. Two factors, however, have multiplied the number of arbitration proceedings from a few hundred cases in the early 1980s to many thousands at present--the Supreme Court decisions and the October 1987 crash. Faced with this enormous influx of new hearings, the system has attempted to cope by doing what is expedient under the circumstances, with no apparent long-term planning for the establishment of cohesive, responsive procedures. It is, to analogize, similar to a sprawling city which continually adds new roads and highways to an already patchwork scheme without rhyme or reason, rather than one with a thoughtful plan for the future. Both the NASD and NYSE have responded to the increase in cases by hiring additional "arbitration administrators" and in the case of the NASD, opening several regional arbitration offices. While the increase in personnel undoubtedly expedites the flow of paperwork, it does not address the fundamental problems in the existing arbitration system. No investor will be confident that he or she can get a fair hearing until (i) a reasonable, structured and well-managed discovery process is established; (ii) an expanded list of arbitrators is created; (iii) parties are afforded a realistic opportunity to select the arbitrators; and (iv) a uniform basis for assessing liability and damages is created.

After the October 1987 crash, the SEC mandated certain changes in the pre-hearing discovery process, including a requirement that the parties "cooperate" in the exchange of documents and information within a prescribed time period. Nice sentiments, but without a realistic enforcement mechanism, even this is of little value. While a document request may be sent out almost immediately after a proceeding is initiated, and requires a response within 30 days (under the uniform rules) no realistic recourse presently exists if a response is not forthcoming. Unfortunately, in most cases, parties (on both sides) continue to ignore these time periods. The NASD and NYSE state that arbitrators may be asked to rule on discovery disputes -- but in practice no arbitrators are even appointed until several weeks before a hearing is scheduled. By that time, it is generally far too late to make full use of the requested materials or to seek other documents from outside sources.

The composition of the pool of arbitrators is a matter of alarming concern. For all intents and purposes, the arbitrators for each case are selected by the single arbitration administrator assigned to that case. As a consequence, an investor who once had an opportunity to utilize the state and federal judicial systems, to be assigned an array of judges, and to select from a panel of peers as jurors, is at the mercy of the judgment of one of a handful of such arbitration administrators. Those arbitration administrators are selected, in term, by the directors of arbitration of the NASD and NYSE. This, in essence, two individuals now direct the entire process for thousands of cases which formerly enjoyed the protection of an experienced and diverse judicial system.

One mechanism that the NASD and NYSE have refused to apply but which has historically been utilized by the American Arbitration Association is that of allowing the parties to narrow the field of arbitrators. By this process, both sides would given a list of arbitrators, directed to eliminate those who were objectionable, and asked to list the remainder in order of preference. Theoretically, this provides the parties with an opportunity to eliminate those arbitrators most likely to bring a predeposition to the proceeding. The process is not infallible; it is infinitely more desirable than the existing alternative wherein the parties simply told -- here are your three arbitrators.

An even more effective alternative would consist of efforts to expand the pool of arbitrators to include those who are not already familiar with the arbitration administrators. Arbitrators should be sought from a cross-section of the general public which includes customers of brokerage firms as well as the existing panoply of brokers, traders and lawyers. The industry is already in possession of a source of such potential arbitrators -- its own customers lists. I can think of no greater affirmation of the intention to create a fair arbitration system than the inclusion of investors in the pool of arbitrators. At the least, it would provide further demonstration of the efforts of self-regulators to balance a system which is preserved as inherently biased. At best, it would actually make the process more fair and restore a needed deterrent to wrongdoing brokers who would now be judged by a "jury" which includes both their peers and those of the complaining customer.

The security industry breathed a collective sigh of relief with the _MacMahon_ decision. Among its repercussions, _MacMahon_ virtually eliminated the wildcard in any litigation -- the possibility of punitive damages. The Sword of Damocles which hung over the head of every brokerage defendant in a court proceeding was the possibility that a jury could award punitive damages -- and they did so often enough to make this fear realistic. This concern about punitive damages was a compelling impetus behind the industry's thrust in favor of arbitration; punitive damages meant higher awards and, in many cases, settlements at higher amounts than the brokerages might have otherwise wished.

Arbitration eliminated that fear. In general, the self-regulators have adopted the position that arbitrators are entitled to act as permitted under state law. Many states, including New York where most of the industry is headquartered and most cases are heard, do not permit arbitrators to award punitive damages. Consequently, the possibility of an extraordinary award where the broker has acted fraudulently or in furtherance of an unlawful conspiracy has been eliminated. On the other hand, other states such as Florida, permit awards of punitive damages and attorney fees. Consequently, results are not uniform. They are even more dramatically skewed because arbitrators, in their Solomonaic wisdom, are far more likely to "split the baby" in the first place than to award the customer all of his or her losses plus exemplary damages.

This inequity cries out for a remedy. Uniform rules of relief must be established -- if arbitration is mandated and justified by the Federal Arbitration Act, there is no reason for a customer in one state to possess greater remedies than one from another state. The question of punitive damages must be placed within the discretion of the arbitrators regardless of the state where the hearing is actually held.

The Right to Choose

In response to MacMahon, the State of Massachusetts enacted legislation (supported by 30 other states) which would prohibit brokerage firms from requiring customers to sign arbitration agreements. The lower federal court have declared this legislation to be an unconstitutional interference by the state in an area which is preempted by federal law. The Supreme Court is now considering the viability of these decisions.

The Massachusetts legislation provides the basis for a return to the sane and balanced days which preceded Byrd and MacMahon. It is also consistent with both of those decisions, which conclude only that a customer who has actually signed such an agreement is compelled to arbitrate.

There can be no compelling argument by those who would deny this option to investors. Brokerage firms suggest that the costs of litigation would create a greater business expense, but certainly no greater than those borne by other industries which are compelled to defend claims before the courts. Nor does it seem that arbitration would be abandoned. In truth, arbitration, once this process is refined, presents a most efficient, inexpensive and expeditious process for all parties. Any thoughtful customer or customer's attorney would still remain inclined to pursue arbitration in most instances. But the existence of an option would send a message to the brokerage industry to operate with greater care, impose greater supervision, and to make an effort to solve customer disputes. Brokers understand options. Indeed, nothing seems to form the basis for more customer complaints than option trading. If the Court should reject the right of the states to institute such legislation, it will fall upon Congress to pick up the mantle of its constituents and enact federal legislation preserving the option.

There should be little difficulty for the industry to adjust to the "arbitration option" as well as it has to the equity option, the index option and the myriad futures options which are traded daily. It would mean only that the securities industry recognizes the risks of dealing with customers. This is little to ask of an industry which regularly asks customers to acknowledge the risks of dealing with brokers.

Senator **Bryan**. Mr. Bernstein, thank you very much for those most thoughtful comments.

Let me just follow-up, if I may. You set out some criteria, some features that ought to be incorporated in an arbitration system that is fair to the investor. Is there such a model that you could point to that in fact includes the various points that you think are essential to provide fairness and objectivity?

Mr. **Bernstein**. I think the model has to be derived from a number of sources. There are elements of that model. For instance, there are elements of that model in the American Arbitration Association in terms of the selection of arbitrators. There are perhaps no elements of the model for one important aspect, which I did not mention, which is the uniformity of assessing damages.

At the moment, I can represent a customer who has precisely the same claim in Florida as one who has a claim in New York. But in Florida, he is entitled to get punitive damages and attorney's fees, and in New York, he is not. That is because the self-regulatory organizations take the view that arbitrators are governed by what the State law permits an arbitrator to do.

If arbitration in securities cases is really to exist under the Federal Arbitration Act, then it is imperative to promulgate some uniform standards, so that the ability of a customer to recover does not depend on the good fortune of where he happens to be.

Senator **Bryan**. So you are arguing, in effect, for Federal preemption of the interest in uniformity of damage criteria that insofar as possible result?

Mr. **Bernstein**. Because the industry has already stated and argued that Federal preemption is what creates the system. I am only asking for consistency.

Senator **Bryan**. In developing that model, does that have to be something that is done at the congressional level? Is the vehicle available out there, and the mechanism in the marketplace, the regulatory structure, such as it exists right now?

Mr. **Bernstein**. I do not think that the vehicle exists right now which is going to put that model into place. I think that some mechanism, whether it is a committee that consists of, as I would suggest, the heads of arbitration of the NASD and the New York Stock Exchange and the AAA, and perhaps two or three representatives of investors and two or three representatives of brokerage firms—to create that model, and to mandate that model. But I do not believe the mechanism exists at the present time.

Senator **Bryan**. And presumably, a group that is so constituted would then make its recommendation back to what? The SEC? The Congress? How would we make sure that that is in fact implemented?

Mr. **Bernstein**. I think that the place for it to make its recommendation would be to the Congress. And the place for the recommendation should be in legislation.

Senator **Bryan**. Mr. Smiley, do you have any thoughts on the arbitration? I have got a number of other questions. Mr. Bernstein outlines a fairly detailed proposal that makes a lot of sense, at least to this Senator. But you have had a lot of experience; do you share his concerns, and do you agree with what he is recommending?

Mr. **Smiley**. I certainly share his concerns. And with the exception of minor details about who puts forward the rules and who gets first crack in putting them together, I believe I share his sentiments.

I think that the SEC has recently shown itself to be very concerned about the arbitration process, and has initiated some very useful reforms. Given their track record, given their concern and the impact I have seen in the cases that I am handling, I think the impetus should come from the SEC in conjunction with the self-regulatory organizations. They are pretty close to the problems.

There are some serious problems of a substantive nature with arbitration. I say that, even though I think it is a fundamentally fair process. I do not think it is perceived as fair, but I think it is basically fair.

The question of uniformity of damages is clearly an issue that needs to be addressed. I think the proper legal view is that this is a Federal process, it is not 50 different State arbitrations, and there ought to be Federal rules governing damages. Some of the courts say that, some of the courts do not. And it is, to my mind, ridiculous that in Georgia I can get punitive damages on a claim, in New York, for exactly the same conduct, you could not get punitive damages.

Also, the same issue exists with regard to attorney's fees. The hard fact of the matter is that most investors who lose investments will never be able to afford an attorney to go back and try to recover their losses, particularly if you are the Thomasons and have lost $17,000, and that is what you have got, that was your money. Some provision needs to be made so that you can get an attorney to go in and represent you. And most of these people cannot afford to fight a legal battle, dollar-for-dollar, against a large brokerage firm, with no hope of recouping attorney's fees at the end of the process.

A major concern I have about arbitration right now, and I think the reason why people do not trust the process, is that it is shrouded with excessive secrecy. If a doctor is sued for malpractice, if an accountant is sued for fraud, if a lawyer is sued for malpractice, their cases are tried in a public courtroom. If other people want to know what happened, if they had gone to the same doctor or accountant or what-have-you, they can listen to the evidence. If the press wants to know what is going on, they can listen to the evidence.

Arbitrators close the record, they close the proceedings. Sometimes, I am surprised that nobody from the media has tried to get in on an arbitration case and listen to what is going on. I know the result: they would not be allowed in the room. And I think that is unfair.

I do not know whose interests, other than the securities industry's, are served by being able to have secret adjudication. In fact, increasingly the cases that are being brought to arbitration, particularly after McMahon, are the really serious fraud cases. Securities fraud and racketeering claims now must be sent to arbitration. Almost by definition, those are the sorts of claims that involve lots of investors.

You are also getting a new species of litigation which I guess you have to call "products liability litigation," where the problem is not that one broker has hurt one client's account, and it is not a personal credibility problem, but that the firm mismarketed a product. They called something safe and secure and stable, and it was a disaster.

Those cases are being heard in arbitration now, and when those cases are being decided nobody is hearing about the results. Yet, there may be thousands of investors who bought the same defective product.

You heard Mr. and Mrs. Thomason talk about how they found out what happened with Blinder Robinson; they read a newspaper article about a class action that was filed. If those plaintiffs had filed an arbitration, the Thomasons would never have heard of it. They never would have seen the press account, and they would have never known what happened.

I think this secrecy is a very serious problem, and I think that the arbitration process favors the industry by letting it cover up its faults, and disserves the public by not revealing more about what is going on in arbitration.

Senator BRYAN. Mr. Smiley, you made a comment as part of your opening testimony that the failure to disclose the nature of the commission or the compensation that the brokers and their representatives get is a temptation that is irresistible, to put words into your own mouth. We have similar testimony in our hearing in Nevada.

In fact, we had one individual who had formerly been in the business, had a revelation on the road to Damascus, and renounced his former sins, and now is a great advocate for reform. And he argued, in effect, that we are never going to get to the bottom of this thing, even with the cold calling rule and some other things that are at least attempting to be helpful in addressing it, until we have eliminated that problem. There is just so much potential money to be made there that it is almost impossible.

Now, in our Small Investor Protection Act, we have a disclosure provision on the confirmation slips. The problem that you mentioned, is that really going to get to the bottom of this, or do we have to go further?

Mr. SMILEY. I guess my concern is that, as many technical ways as a bill may be written, there will be a way around it. The issue of mark-ups, which is the form of compensation earned by penny stock brokerage firms, is one that has been the subject of administrative proceedings and SEC proceedings for years.

What you have is a scenario where the brokerage firm uses a totally artificial number as the basis of how they compute mark-up. They say, "We are going to use 10 cents a share as our mark-up figure, and we are going to mark it up 5 percent from there." That figure has no relationship whatsoever to the firm's profits. They are probably paying 5 cents for the same stock.

I think, if you got, perhaps, to a system where the individual stock broker's compensation was disclosed, and the firm profit based on what it cost them to acquire the security that they were selling to the client, if that were disclosed, that might get something done.

Senator BRYAN. In effect, the spread.

Mr. SMILEY. The spread.

Senator BRYAN. Mr. Bernstein, are there any comments that you might have in this area?

Mr. BERNSTEIN. Yes. Of course, it is a broad problem. It does not, again, just affect the penny stock situation. Because any time a broker makes a market in a security and sells it as a principal, the problem of spreads arises. I agree.

Probably, the best way to deal with it is in terms of maximizing the disclosure to the public of what in fact that spread is. With listed securities, of course, the NASD has some standards as to what the spread is supposed to be. But even those standards do not really get to the heart of the matter, because it is difficult, if not impossible, to determine what that real acquisition cost was from the brokerage firm. So the spread is always greater than it appears to be. Disclosure would seem to be the only course to attack it on.

Senator BRYAN. Let me shift the focus a little bit, and let's talk about the sleaze factor, people that are in this business, those that prey upon the Mr. and Mrs. Thomasons of the world, and even those that may at least ostensibly be more sophisticated in these matters but who nevertheless are victimized.

How effective are we in preventing those folks from ever getting back into this business under any form, ruse, or guise? The kind of folks that are involved here, Blinder Robinson, the people that Mr. and Mrs. Thomason dealt with, and the hundreds, if not thousands of those who have been involved in that kind of practice, do we effectively keep them out, prospectively, once their misconduct is noted?

Mr. Smiley?

Mr. SMILEY. I think the answer is, we do not.

Senator BRYAN. What do we need to do?

Mr. SMILEY. We need to make sure that there is better disclosure of brokerage firms about complaints against brokers. There has got to be better disclosure about administrative actions against brokers. There has got to be greater follow-up, particularly by the States when they see complaints filed against particular brokers.

Senator BRYAN. Now, I noted—and I have never been involved in a securities practice, but I did practice a little law, once upon a time. I noticed that Mr. Wilson was very careful in terms of the disclosure with respect to disciplinary violations.

And he seemed to suggest to me that only in those instances in which there had been an adjudication in which a determination or a decision had been rendered adverse to the broker or dealer, was that information made available.

Did I understand correctly, Mr. Smiley, that that was what he was saying? Or, Mr. Bernstein?

Mr. SMILEY. That was the way I heard it. And that is the position I have heard from a number of regulators.

Mr. BERNSTEIN. That is my understanding of what the standard of disclosure is at the NASD.

Senator BRYAN. Which is a hell of a lot different from what you are talking about.

Mr. BERNSTEIN. Absolutely. The level of disclosure about people who have been barred, or whose integrity has certainly been under attack, is de minimis. Even the ability to obtain the few facts from the NASD in terms of actual disciplinary proceedings really does not take the customer very far. And the customer in general must possess a certain degree of sophistication before he or she gets to the point where he or she is going to ask for that kind of information.

One of the earlier speakers talked about attacking this like the drug problem, getting rid of the source of the problem, like attacking the source of the drugs. I think it has to be attacked like the drug problem in a different sense. We attack the drug problem by going and trying to educate the public and discouraging the user. I think that the consumer and the public need to be educated and need to become more and more self-aware.

The process has begun. But the customer has the best ability to protect himself or herself; and that is, not to buy these securities, and not to deal with these people. The customer would best serve himself who would make sure that they investigate what they are doing before they move forward, and who would read these forms before they sign them, and who would not allow themselves to be persuaded by a broker to just sign the form even though the numbers are wrong, as they often are.

In many cases, we hear of brokers who tell their customers, "Well, I had to put in this amount of assets with this amount of income. Otherwise, my branch manager would not let you trade the option." Frankly, that is because the person should not be trading the options. They should not be on margin, and they should not be buying and selling puts and calls. And the customer has got to provide his own first line of self defense and say, "I am not signing agreements that are not accurate, and I am not signing things I have not read, and I am not dealing with someone who I have not checked out."

Senator BRYAN. This disclosure, what is the mechanism for providing for broader disclosure of a disciplinary background or problem that an individual has had? What form does that take? What mechanism?

Mr. BERNSTEIN. One mechanism would be to allow the customer and the investor access to all complaints that had been filed against the broker, and against the firm. Because usually, particularly in the penny stock area, a problem is going to be endemic to the entire firm, and there are going to be other people at that firm that have done similar things, engaged in similar misconduct.

So I think they have to open up the whole avenue of secrecy, not only the secrecy at the level of hearings, but secrecy in terms of where people have been, why they have left, and how they got where they are today.

Senator BRYAN. In effect, part the veil.

How about the other aspect of the problem? And that is, aside from the rather limited disclosure, individuals that do have bad track records, who have been around the track a few times on the periphery, the folks who are involved with the Thomasons, how many of those get back into the business? Is there a pattern there? Is there a problem with these folks?

Mr. Smiley, you may have an observation.

Mr. SMILEY. The repeat offenders.

Senator BRYAN. That is what we are talking about, recidivists.

Mr. Smiley. They are all over the place. They are at the tops of some of these penny stock brokerage firms. You have got Meyer Blinder, who is still running Blinder Robinson. The SEC has been trying to bar him for life. The company is still doing business.

There is a district court case in Pennsylvania, in which a judge has made a preliminary ruling that Blinder is operated as a racketeering enterprise, and the money from Blinder is going to Hong Kong right now. That is the top of one of the major firms.

At the lower levels, what you see are people who get caught doing something wrong with one firm, but they have got a good book of business, so they move to another firm. They do the same offense at the second firm, and sometimes a third, fourth, and fifth. fifth.

When you look at who these people are, we have found brokers who are operating under aliases, who have been at multiple firms. We have found brokers with criminal records. One guy had just been paroled for drug violations and other criminal offenses, and he was hard at work selling securities with a seemingly reputable brokerage firm.

Obviously, the industry—and I do not limit this to the penny stock industry at all—is not doing a good job at who they are giving their series 7 licenses to, and they are letting these people use their series 7 securities license as a license to steal. And frankly, as long as the commissions they generate are substantial, and as long as they do not pay out too much in damages, or get too much regulatory heat, they tend to tolerate these people.

Senator Bryan. Mr. Bernstein, your observations?

Mr. Bernstein. This is really a problem that falls on the doorstep of the regulators. Every time a broker leaves a firm, he fills out what is called a U-5 form saying that he is departing and why he is departing, and supposedly listing, if he has had problems, what those problems are, and when he goes to join a new firm, he has to fill out a U-4 form, which lists any regulatory problems he has and any proceedings that have been pending against him.

The question is, why that broker when he submits the new U-4 form gets the license again. Certainly, the mechanism exists to stop these people from getting back in the industry, but they all seem to turn up again. Nobody seems to disappear unless they want to.

Senator Bryan. As you are suggesting, that is a function of the enforcement process.

Mr. Bernstein. No question about it.

Senator Bryan. Why do you suspect that there is not better enforcement?

Mr. Bernstein. I suspect that perhaps there is not enough personnel, or enough attention paid to making sure that the people who have had problems in the past, if they are going to get back into the industry, get back in the industry under the most severe supervisory standards possible.

Occasionally, the self-regulators and the SEC do mandate extraordinary supervisory standards for these people to get back in the industry. Sometimes, those people do not even deserve that opportunity. But far more often, the forms simply seem to be processed. And I do not know why.

Senator **Bryan**. Do you have a sense, Mr. Bernstein, that the forms, the U-4, the U-5 that you are talking about, are they accurate so that one who was properly motivated to be aggressive in rooting this kind of problem out would be charged with notice that, yes, indeed, there is a history? Or, is the problem that the form itself is incomplete, misleading, or simply not filled out accurately?

Mr. **Bernstein**. In most cases, they seem to be accurate and I believe I am correct that in most cases they are also submitted in connection with fingerprint cards. So the mechanism for finding out who this person is, even if he uses an alias, would exist. It just needs the personnel and the intent to enforce it.

Senator **Bryan**. The testimony from all of you has been most helpful today. As you know, there are a couple of pieces of legislation. There is the bill which I have just introduced, S. 2057, which deals with a couple of aspects. That is the spread issue which you are talking about, requiring further disclosure, that would eliminate the blind pool and the blind check problem.

I would appreciate it, if you get a chance, if you would take a look at that. Be as critical as you choose to be, where you think it could be stronger, and where you think we may have missed the mark. We would appreciate your comments. I know you are both in the private sector, and your time is valuable. But we certainly would appreciate it.

Mr. and Mrs. Thomason, we appreciate very much your coming here. We could talk about these things as abstractions, and most of us cannot even comprehend what $2 billion is, but we can relate to people like yourselves who are folks of modest income, with their life savings at risk, and all of a sudden that looks like it vanishes before your very eyes. That makes this whole proceeding a little bit more meaningful. So your attendance here this morning was most appreciated.

This will conclude our subcommittee hearing this morning. We will stand in recess.

[Whereupon, at 11:45 a.m., the hearing was adjourned.]

[Responses to written questions and additional material supplied for the record follow:]

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

April 6, 1990

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Riegle:

I am enclosing my responses to questions from you and other members of the Committee regarding S. 647, the "Securities Law Enforcement Remedies Act of 1990" and other matters, which were submitted following my February 1st testimony before the Securities Subcommittee.

In addition, several members of the Committee, as well as Congressman Lee Hamilton in a letter to Chairman Dodd dated January 29, 1990, have asked about allegations relating to Cummins Engine Company and the Commission's enforcement of the Schedule 13D disclosure requirements. Section 13(d) of the Securities Exchange Act of 1934 and Rule 13d-1 thereunder generally require a person who becomes the beneficial owner of more than five percent of a class of the outstanding equity securities of a publicly traded company to file within ten days of acquiring such ownership a statement on Schedule 13D with the Commission and to send copies of the statement to the issuer and to any exchanges where the issuer's securities are traded. Item 4 of Schedule 13D requires that the filing persons state the purpose or purposes of their stock acquisition and describe any plans or proposals they have which may relate to or result in, among other things, an extraordinary corporate transaction, such as a merger, reorganization or liquidation of the issuer.

Enforcement of the disclosure requirements under Section 13(d) of the Exchange Act has been a significant priority of the Commission's Division of Enforcement. Currently the staff has a number of ongoing investigations that specifically concern the adequacy and accuracy of disclosure under Item 4. Many of these investigations involve filing persons who reported holding the subject securities for investment purposes only or who explicitly disclaimed any purpose to change or influence control of the issuer. As with many provisions of the federal securities laws, Section 13(d) requires, in the first instance, that the filing person comply with the laws and make complete and accurate disclosure of the purpose of the investment. In cases where serious questions exist regarding the accuracy and completeness of such disclosure, circumstantial evidence almost always is the only proof available to challenge any specific disclosure and to persuade a trier of fact that a person has misstated or omitted to state the purpose, plans or proposals relating to an investment. Accordingly, investigations of Item 4 disclosures often require substantial staff resources to review documents relating to matters such as the filing person's history of stock acquisitions and the purchases and financing of the securities subject to the filing under investigation, and to examine many witnesses.

In addition to the Commission's enforcement efforts, as in other areas of the federal securities laws where private rights of action are available to enforce the requirements of full disclosure, the enforcement of Item 4 of Schedule 13D depends in part on the self-policing role that private litigants play.

The Commission has recently brought several significant cases enforcing the requirements of Item 4. In SEC v. Edward P. Evans, et al., Civil Action No. 89-3285 (D.D.C. filed Dec. 6, 1989), the Commission filed an injunctive action against three former officers of Macmillan, Inc. who had served as trustees of an employee stock ownership plan. Although the defendants disclosed that the purpose of the ESOP's purchase of 1.2 million shares of Macmillan common stock was "in furtherance of the purpose of the [Macmillan ESOP]," the Commission alleged that another purpose of the purchase, which was not disclosed, was to further defendants' plan to undertake a recapitalization of Macmillan. The defendants consented to an injunction prohibiting them from violating Section 13(d) of the Exchange Act and Rule 13d-1 thereunder, without admitting or denying the Commission's allegations.

In another recent case, SEC v. Paul A. Bilzerian, et al., Civil Action No. 89-1854 (D.D.C. filed June 29, 1989), the Commission alleged, among other things, that Paul Bilzerian, the former Chairman of the Singer Company, violated Item 4 by stating that the purpose of acquiring a 9.9% position in Cluett Peabody & Co., Inc. was "to attempt a leveraged buyout when, in fact, the purpose was to pose a credible takeover threat in order to force Cluett management to pay greenmail or to seek out a white knight." Complaint at ¶ 51(d). The Commission's action is pending in federal district court.[1]

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[1] Other cases include SEC v. Amster & Co., 88 Civ. 8587 (CSH) (S.D.N.Y. Dec. 5, 1988) (alleging that a Schedule 13D stating that securities were held for investment purposes

(continued...)

As these cases demonstrate, enforcement of the disclosure requirements under Section 13(d) of the Exchange Act has been a significant priority of the Commission and its Division of Enforcement.

The Commission as a matter of general policy does not comment concerning any particular matter that may be the subject of a Commission investigation. That policy is designed to protect the privacy of individuals and entities whose activities are under investigation, as well as the integrity of the Commission's deliberative process, and is consistent with the mutual interest of Congress and the Commission in the independence of the Commission's investigative process and with the concerns expressed by the federal court in Securities and Exchange Commission v. Wheeling Pittsburgh Steel Corp., 482 F. Supp. 555 (W.D. Pa 1979), vacated and remanded, 648 F.2d 118 (3d Cir. 1981).

If you should have any other questions concerning S. 647 or the matters addressed in this letter or in my responses, I would be happy to discuss them with you. In addition, please feel free to contact Daniel L. Goelzer, the Commission's General Counsel, at 272-3171, to discuss any aspect of the legislation.

Sincerely,

Richard Breeden

Richard C. Breeden
Chairman

Enclosures

(Similar letters sent to Chairman Dodd
and Senator Sasser)

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[1] (...continued)
only was false and misleading because filing persons had begun actively planning and soliciting support for a proxy contest to take control of the issuer); In the Matter of Sequa Corp., Securities Exchange Act Release No. 26,839 (May 19, 1989) (administrative proceeding pursuant to Section 15(c)(4) of the Exchange Act finding that filing person who had decided to acquire 20% interest in public company did not promptly amend Schedule 13D to report this change in purpose).

Question from Senator Nancy L. Kassebaum

Private Rights of Action

> The Commission has previously expressed the view that private litigation serves as a necessary supplement to its own enforcement efforts. In fact, the Commission has, in the past, proposed legislation which would expand the availability of private rights of action. For example, the Commission proposed in 1980 to create express private rights of action for Williams Act violations. What is the Commission's present view of private rights of action under the federal securities laws, especially in light of resource constraints? For example, two of the takeover bills introduced by members of this Committee provide for express private rights of action to enforce the margin rules. Do you support this approach?

The Commission has taken the position that, in light of the Commission's limited resources, private rights of action afford a necessary supplement to Commission enforcement actions. See, e.g., Brief for the Securities and Exchange Commission at 26 n.31, Basic Inc. v. Levinson, 485 U.S. 224 (1988). However, the availability of an implied right of action depends upon the language and legislative history of the particular statutory provision at issue. For instance, while the existence of an implied right under Section 10(b) and Rule 10b-5 is well-established, the existence of an implied right of action for a tender offer target under Section 7 is unsettled. There are conflicting cases on this question. As Senator Kassebaum's question notes, several legislative proposals currently pending in Congress would grant tender offer targets and their shareholders an express right of action under Section 7. In a letter dated January 4, 1990, the Senate Securities Subcommittee requested the Commission's comments on, among other things, these legislative proposals. The Commission's comments will be forthcoming in a separate statement.

Questions from Senator Donald W. Riegle, Jr.

1. Disgorgement

> The penalty provisions of the Securities Law Enforcement Remedies Act are intended to be independent of disgorgement of any profits obtained by the securities law violator as a result of the wrongful conduct. Please suggest clarifying language for S. 647 to ensure that both disgorgement and the penalties provided in the bill can be obtained from securities law violators.

The Commission did not include such language in the legislation as submitted, because it did not believe that the language was necessary. The provision in S. 647 for penalties in civil actions was based upon Section 21A of the Securities Exchange Act of 1934 and its predecessor, the Insider Trading Sanctions Act. Both Section 21A and S. 647 provide that the civil penalty actions that they authorize may be brought in addition to any other action that the Commission or the Attorney General is entitled to bring. The legislation that the Commission submitted to Congress on February 9, 1990 contains similar language. This language makes clear that a penalty action is not an exclusive remedy, and that an action for disgorgement also would be available in appropriate cases.

Although neither Section 21A nor ITSA expressly referred to disgorgement, the courts have routinely ordered disgorgement and penalties in the same case. *See, e.g.*, *Securities and Exchange Commission v. John N. Clark*, No. 87-711Z (W.D. Wash. 1989) *appeal docketed*, No. 89-35486 (9th Cir. July 21, 1989) (Lit. Rel. Nos. 12056 and 12111); *In the Matter of Ivan F. Boesky*, Civil No. 86-8767 (S.D.N.Y. Nov. 14, 1986). The legislative history of ITSA reflects that Congress and the Commission intended that other remedies, including disgorgement, continue to be available to the Commission. *See* H.R. Rep. 355, 98th Cong., 1st Sess. 9, 20, 25 (1983).

Questions from Senator Donald W. Riegle, Jr. (cont'd)

2. Treble Damages

> **The Insider Trading Sanctions Act of 1984 provided a maximum penalty of three times the profit gained or loss avoided as a result of an unlawful purchase, sale or communication. In recommending the Securities Law Enforcement Remedies Act, the Commission has requested a variable penalty structure in which the amount of the penalty does not exceed $100,000 per violation of violations by natural persons, $500,000 per violation by any other person or the gross amount of pecuniary gain to the defendant as a result of the violation. Why has the Commission not recommended the treble damages penalty structure used in the Insider Trading Sanctions Act for the Securities Law Enforcement Remedies Act?**

The purpose of the treble penalty provision in the Insider Trading Sanctions Act was to enhance the Commission's ability to deter violations of the insider trading prohibition. At the time ITSA was enacted, insider trading had become widespread. There had been an increase in the number and size of mergers and tender offers, often resulting in immediate and dramatic price movements in the stock of a target company. There also had been tremendous growth in the options market, in which a small investment can yield enormous profits if the price for the underlying stock increases after a tender offer or other announcement. Congress was concerned that "this potential for immense profits [was] a lure" to insider trading, and adopted a treble penalty provision in order to remove the economic incentive for engaging in this activity. H.R. Rep. 355, 98th Cong., 1st Sess. 5 (1983).

S. 647 would authorize penalties in civil actions for securities law violations other than insider trading. Many of these violations do not entail substantial profits to the violator, and in many cases the amount of the profits may be difficult to prove. Consequently, the provision in S. 647 for maximum penalties equal to the greater of the pecuniary gain to the defendant or $500,000 ($100,000 for an individual) per violation generally will be more appropriate for the violations that would be addressed by S. 647.

Questions from Senator Donald W. Riegle, Jr. (cont'd)

3. SROs

The Securities Law Enforcement Remedies Act does not strengthen the Commission's enforcement tools over the various self-regulatory organizations. Do you believe the Commission should have the authority to impose civil money penalties on the various self-regulatory organizations?

The Commission currently has substantial authority over the operations of the SROs. When an SRO has failed to meet its regulatory responsibilities, the Commission can require the SRO to increase its expenditures on its oversight and supervisory activities. During the course of its examination of an SRO's enforcement program, the Commission staff makes recommendations for improving the SRO's program. These recommendations often include the hiring of additional personnel, the acquisition of improved market surveillance equipment, or other improvements that require additional expenditures by the SRO. In some situations, a fine might reduce the SRO's resources available to implement these recommendations or to otherwise meet its statutory requirements. The statutory responsibilities of the SROs and their not-for-profit status distinguish them from the profit-seeking entities otherwise subject to the Commission's administrative jurisdiction.

In addition, the Securities Exchange Act of 1934 provides the Commission with several other means of influencing an SRO's operations when it has not fulfilled its regulatory responsibilities. Under Section 19(h)(1), the Commission may censure or impose limitations upon the activities, functions, and operations of an SRO if it finds that the SRO has violated or is unable to comply with the federal securities laws or its own rules or without reasonable justification or excuse has failed to enforce compliance by its members with certain relevant regulations. Under Section 19(c), the Commission may amend the rules of the SRO to conform them to the requirements of the federal securities laws. Moreover, under Section 19(g), it may relieve any SRO of any responsibility under the federal securities laws to enforce compliance with those laws against any of the SRO's members or persons associated with the SRO's members. Finally, under Section 19(h)(4), the Commission may remove from office or censure any officer or director of an SRO if it finds that person has willfully violated the federal securities laws or the SRO's rules, has willfully abused his or her authority, or without reasonable justification or excuse has failed to require SRO members or participants to comply with relevant regulations. This wide-ranging authority over SROs is much broader than the Commission's comparable authority over other entities.

For these reasons, the Commission believes that the goal of ensuring fair and orderly securities markets is adequately served by relying on the Commission's substantial disciplinary authority and influence over the SROs, rather than by seeking authorization to assess penalties against them.

Questions from Senator John Heinz

1. Full Disclosure

A principal tenet of our federal securities laws is "full disclosure." The rational for full disclosure is that shareholders and investors, armed with all the facts, can make informed investment and corporate governance decisions. Under current law, an officer or director who has been found to have violated the federal securities laws must fully disclose this fact to shareholders and investors. The shareholders and investors can choose to vote the director out of office and/or sell their investment in the company.

a. The SEC's request for authority to bar individuals who violate the federal securities laws from serving as officers and directors of public companies suggests that full disclosure is not adequate to protect shareholders and investors. Is full disclosure adequate? If not, why?

b. What, if any, examples are there which demonstrate the inadequacy of full disclosure in protecting shareholders and investors in public companies from officers and directors who have disclosed their violations of the federal securities laws?

In most situations, full disclosure of information concerning officers and directors of public companies will provide adequate protection to investors. However, there are situations in which full disclosure may not be sufficient. For example, the Commission has obtained court-ordered bars in cases in which the violator is the controlling shareholder or one of several violators who control a company's voting stock. See, e.g., SEC v. John Forma, et al., Civil No. 85-3820, Lit. Release No. 10766, 33 SEC Docket 317 (S.D.N.Y. May 24, 1985); SEC v. El Dorado International, Inc., Deil O. Gustafson, et al., Civil No. 81-0532, 22 SEC Docket 392 (D.D.C. Mar. 5, 1981); SEC v. American Commonwealth Financial Corp., et al., Civil No. C.A. 3-77-0648, Lit. Release No. 7920, 12 SEC Docket 421 (N.D. Texas May 12, 1977). In those situations, even if there were full disclosure of prior securities law violations, the violator could elect himself to the company's board of directors or have himself named as a company officer.

In any case, the Commission is seeking Congressional endorsement of authority that federal district courts already possess to order officer and director bars pursuant to their inherent equitable powers. Courts have exercised this authority in many Commission cases settled by consent and in at least one litigated case. The cases in which the Commission has sought and obtained this remedy warranted it because of the egregiousness of the violator's illegal activity. See, e.g., SEC v. Charles W. Anshen, et al., Civil No. CV-S-86-862-LDG, Lit. Release No. 11618, 39 SEC Docket 1280 (D.Nev. Dec. 2, 1987) (fraudulent issuance of millions of shares of unauthorized and unregistered stock worth in excess of $5 million).

Questions from Senator John Heinz (cont'd)

2. State Law

Some critics of S. 647 have suggested that the authority to bar officers and directors is a preemption of state laws governing the qualifications of officers and directors.

a. Will the SEC's authority to bar officers and directors preempt state laws?

b. How does the SEC respond to critics who claim that this provision is an unwarranted intrusion into state corporate governance laws and the initiation of federal corporate law?

While corporate governance issues are generally regulated by state law, the use of such a corporate bar to deter violations of the federal securities law is not new. As discussed in the answer to the question above, courts have entered corporate bar orders in many Commission cases settled by consent and in at least one litigated case. Moreover, in many Commission enforcement actions, courts have appointed receivers and special agents, removed or appointed directors, and taken other actions that were functionally equivalent to a corporate bar because corporate officers were precluded from performing functions and exercising powers contemplated by state law. The Commission's proposal would merely reaffirm the courts' authority to impose corporate bars for violations of Section 17(a)(1) of the Securities Act or Section 10(b) of the Exchange Act or the rules thereunder. This limited provision would furnish additional protection to shareholders from the most serious violators, without significantly interfering with state regulation of corporate governance.

3. Penalties Against Issuers

S. 647 will enable the SEC and the courts to impose civil monetary penalties against individuals and corporations. In the corporate context, violations of the federal securities laws can be attributed to the actions of officers, directors and employees.

a. Under what circumstances should the corporation be held responsible for the actions of those who caused a securities law violation?

b. What factors should the SEC consider in deciding whether to impose fines against the corporation as opposed to the individuals responsible for the violations?

The Commission believes that the proposed civil money penalty should be applicable to corporate issuers, but should be imposed or sought only when the violation resulted in an improper benefit to shareholders. See Memorandum of the Securities and Exchange Commission in Support of the Securities Law Enforcement Remedies Act of 1989, at 4 (Jan. 18, 1989). For instance, an issuer's violation often produces an economic benefit to shareholders in broker-dealer cases involving the failure to supervise sales practice activities, mark-up cases, and cases involving violations of the customer reserve provisions of the securities laws. Examples of such cases involving other corporate issuers might include the failure to file or to amend promptly a Schedule 13D (thereby permitting additional acquisitions at a lower price), or corporate securities trading in violation of Rule 10b-6 or 10b-8.

In deciding whether to assess a penalty against a corporation, the Commission would consider whether the violation resulted in an improper benefit to shareholders. The Commission also would consider the extent to which the passage of time has resulted in shareholder turnover.

Moreover, the Commission would not ordinarily seek penalties against registered investment companies. Generally, an investment company is a managed portfolio of liquid assets, with all expenses being passed on to shareholders. The proposed legislation would permit civil penalties based on violations of the Investment Company Act, so that fines could be assessed against investment advisers to registered investment companies that violate that Act.

Questions from Senator John Heinz (cont'd)

4. Requirement to Consider Factors (asked at the February 1st hearing)

> S. 647 would enumerate certain factors that the Commission "may" consider in determining whether to impose a fine. Some have argued that the bill should require the Commission to consider these factors. What is your view of this recommendation?

S. 647 would provide a set of factors that the Commission may consider in determining whether a fine is in the public interest. The proposed legislation does not make it mandatory that the Commission consider each of these factors because all of them may not apply in a particular case. The substitution of mandatory language should not, however, change the result in particular cases, so long as it were made clear that the Commission did not bear the burden of coming forward with evidence of each factor.

One of the factors which the Commission may consider is evidence, introduced by the respondent, regarding the respondent's ability to satisfy a monetary penalty. Consideration of this factor should in particular not be mandatory without making it clear that the respondent rather than the staff is required to introduce evidence regarding the respondent's financial position. It would be difficult for the staff to meet this burden if the respondent who generally controls the relevant financial information fails or refuses to make the information available. The Commodity Futures Trading Commission has recently recommended legislation which would delete the provision in the Commodity Exchange Act that requires the CFTC to consider net worth and ability to stay in business when assessing civil penalties. According to the CFTC, this provision has generated considerable litigation, placing an additional burden on the CFTC's enforcement program.

LEE H. HAMILTON
9TH DISTRICT, INDIANA

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January 29, 1990

The Honorable Christopher J. Dodd
Subcommittee on Securities
SD-534
Inside Mail

Dear Chris:

I understand that the Chairman of the Securities and Exchange Commission (SEC) will be testifying before your Subcommittee on Securities this Thursday. I wanted to request your assistance in bringing an urgent matter confronting Cummins Engine Company to his attention.

Cummins Engine Company, an Indiana corporation, is the largest independent diesel engine manufacturer in the world. Cummins is well-known for its high caliber products and its technologically-leading position in the diesel engine market. Its U.S. operations employ 16,000 individuals in 15 states. It invests over $180 million annually on research and development. Through its highly productive, streamlined operations and its competitive pricing, Cummins has managed to maintain its sales despite increased foreign competition.

The future of Cummins Engine, however, is now threatened by the activities of a Hong Kong corporate raider, Industrial Equity (Pacific), Limited.

It is my understanding that, under current U.S. securities law, any entity acquiring more than 5% of a company's stock must file a disclosure statement on Schedule 13D indicating the purpose of the stock purchase. In purchasing 14.9% of Cummins common stock, Industrial Equity (Pacific) indicated the acquisition was for "passive investments". Now, however, Industrial Equity (Pacific) has demanded representation on the Cummins Board of Directors. If this representation is not granted, Industrial Equity (Pacific) has threatened to disrupt Cummins operations or to put the company "in play."

I am very concerned about the potential impact of Industrial Equity (Pacific)'s activities on Cummins Engine. I understand that Industrial Equity (Pacific) has a history of making "passive investments" in companies without disclosing its true intentions and then making threats and demands to obtain tens of millions of dollars in "greenmail" or other transactions. Further, according to a recent financial newspaper article, Industrial Equity (Pacific)'s founder has sought to take advantage of "the new international pursuit of asset stripping."

I would appreciate your assistance in urging the SEC to review

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Industrial Equity (Pacific)'s investment activities with respect to American companies in general, and Cummins in particular. In addition, it would be helpful for Cummins Engine to understand the SEC's position with respect to enforcement of Schedule 13D violations.

Thank you for your assistance with this matter. If I can comment further, or provide you with additional information, please do not hesitate to contact me.

Sincerely,

Lee

LEE H. HAMILTON, M.C.

TO: United States Senate Committee on Banking, Housing and Urban Affairs

FROM: Brian N. Smiley

DATE: February 20, 1990

RE: Response to Questions from Senator Dodd

Here are my responses to the attached questions sent to me by the Subcommittee. As you will note, I have not answered all of the questions, since I do not have an opinion and/or relevant information on some of the points raised.

Legitimacy of the Penny Stock Market

ACCORDING TO THE SEPTEMBER 1989 REPORT BY THE STATE SECURITIES ADMINISTRATORS (NASAA) ON THE PENNY STOCK MARKET, TOTAL ANNUAL PRIMARY AND SECONDARY MARKET ACTIVITY IS ESTIMATED TO BE $10 BILLION, WITH AMERICAN INVESTORS LOSING AT LEAST $2 BILLION EACH YEAR AS A RESULT OF FRAUDULENT OFFERINGS AND SCHEMES.

1. IN YOUR VIEW, IS THERE ACTUALLY A LEGITIMATE PENNY STOCK MARKET? FROM CONVERSATIONS WITH THE STAFF, IT SEEMS THAT THE SEC, THE NASD, AND THE STATE REGULATORS HAD GREAT DIFFICULTY IDENTIFYING WITH A CLEAN, SMALL CAPITALIZATION PENNY STOCK BROKER/DEALER.

(1) I believe that there are many legitimate securities which sell for $5.00 a share or less. I also believe that some legitimate brokerage firms sell these securities, although they do so realizing that they are frequently inherently speculative. These same firms do sell these "penny stocks" at fair prices. Unfortunately, the "penny stock market" seems to be dominated by firms that mass market these stocks, with little or no regard for public investors. These firms do not disclose the inherent risks of penny stocks, and often misrepresent these securities in order to persuade investors to buy them. Also, the firms which operate as retail outlets for these stocks are often the sole or major market maker, thus leading to market domination.

2. DO SUCH CLEAN AND LEGITIMATE PENNY STOCK BROKER/DEALERS EXIST?

(2) "Clean and legitimate penny stock broker/dealers" which specialize in penny stocks may exist, but it is apparently hard to find them. I think that it would be extremely difficult to run a legitimate brokerage firm which specialize in penny stocks, because the number of investors who would be "suitable" candidates for high risk penny stocks is extremely limited.

3. IS THERE A REAL DEMAND FOR PENNY STOCKS? OUTSIDE OF THE SMALL INVESTORS THAT ARE OBVIOUSLY BEING RIPPED OFF, WHAT KIND OF INTEREST IS THERE FOR THIS TYPE OF SECURITY?

(3) In theory, many people are looking for the next Apple Computer, so there may be an inherent demand for inexpensive stocks of new companies. It is hard for me to imagine, however, that there is any real demand (or at least demand by people who have been properly informed), for products such as blind pools and blank checks.

4. AS YOU KNOW, SOME STATES HAVE IMPLEMENTED MERIT REGULATION SECURITIES LAWS. IN CONTRAST TO THE FEDERAL "DISCLOSURE" STANDARD, MERIT STATUTES REQUIRE THAT THE SECURITIES ADMINISTRATOR MAKE A FINDING THAT THE OFFERING IS FAIR, JUST AND EQUITABLE. FOR EXAMPLE, CALIFORNIA, DOES NOT ALLOW PENNY STOCK INITIAL PUBLIC OFFERINGS IF THE ISSUE HAS LESS THAN A TWO DOLLAR SELLING PRICE.

IF THIS WERE IMPLEMENTED NATIONWIDE, WHO WOULD BE HARMED?

(4) No opinion.

5. WHAT DO YOU SEE AS THE REDEEMING AND BENEFICIAL ASPECTS OF THE PENNY STOCK MARKET?

(5) As it currently exists, I do not see any redeeming or beneficial aspect of the penny stock market. I am not convinced that legitimate companies, with sound management, good ideas and prospects cannot find financing through legitimate good underwriters. In fact, I am concerned that good companies may lose their credibility by being brought public through penny stock firms who can destroy investor confidence in the company, regardless of the quality of the product or service being put out by the company being underwritten.

IN THEIR TESTIMONY TODAY, BOTH THE SEC AND THE STATE REGULATORS HAVE URGED THE PASSAGE OF S. 647, THE SECURITIES ENFORCEMENT REMEDIES ACT OF 1989.

ONE PROVISION IN THE BILL GIVES THE SEC AND THE COURTS THE ABILITY TO BAR LAW VIOLATORS FROM SERVING AS OFFICERS AND DIRECTORS OF PUBLICLY HELD COMPANIES, WHICH MANY THINK WOULD BE AN IMPORTANT STEP IN PREVENTING RECIDIVISTS FROM CONTINUING TO DEFRAUD INVESTORS.

1. DOES THE SEC MAINTAIN STATISTICAL DATA ON THE NUMBER OF ENFORCEMENT ACTIONS BROUGHT AGAINST INDIVIDUALS WHO HAVE BEEN PREVIOUSLY SANCTIONED FOR SECURITIES LAW VIOLATIONS?

(1) I do not know the answer.

2. WHAT KIND IMPACT DO YOU FORESEE S.647 HAVING ON THE PROBLEM OF RECIDIVISM, ESPECIALLY IN THE AREA OF PENNY STOCK MARKET FRAUD WHERE REPEAT OFFENDERS SEEM TO CONTINUALLY TO SET UP SHOP AND PERPETUATE FRAUDULENT SCAMS?

(2) S. 647 is a step in the right direction with regard to the problem of recidivist. There is, of course, still the problem of these recidivist becoming involved with the industry as "consultants." Without that loophole being closed, there will be substantial evasion of the intent of S. 647.

3. DO YOU FEEL THAT THE MONETARY PENALTIES THAT MAY BE ASSESSED BY THE COURTS UNDER S.647 WILL SERVE AS A SUFFICIENT DETERRENT TO PENNY STOCK FRAUD PERPETRATORS?

(3) Monetary penalties are certainly useful. These ought to be non-dischargeable in bankruptcy. Monetary penalties and civil remedies are not sufficient, in many instances. Much of the conduct which has been the subject of these hearings is criminal in nature, and only criminal penalties will suffice to deter it.

4. SINCE S. 647 WOULD ONLY PERMIT A COURT TO BAR SECURITIES LAW VIOLATORS FROM SERVING AS OFFICERS AND DIRECTORS OF PUBLIC COMPANIES, HOW WILL THE SEC AND STATE REGULATORS CONFRONT THE PROBLEM OF ILLICIT RE-ENTRY INTO THE SECURITIES BUSINESS, BY THOSE WHO HAVE PUT THEMSELVES OUT AS "CONSULTANTS"?

(4) I do not know the answer to this, but the SEC could alleviate the problem by drafting regulations clearly calling for disclosure in prospectuses where there are "consultants" to underwriters or issuing companies who have been the subject of securities law claims.

IN THE SEPTEMBER 1989 NASAA REPORT ON FRAUD AND ABUSE IN THE PENNY STOCK MARKET, NASAA CONCLUDES "NO CLEAR ECONOMIC JUSTIFICATION EXISTS" FOR "BLANK CHECK" BLIND POOLS.

1. WHAT ARE THE DIFFERENCES BETWEEN A "BLANK CHECK BLIND POOL" AND A VENTURE CAPITAL FUND THAT RAISES MONEY FROM A GROUP OF INVESTORS WHO SEEK RETURN ON THEIR INVESTMENT IN SMALL BUSINESSES OR START-UP COMPANIES?

(1) I defer to the SEC on this question, but in my experience, venture capital funds typically involve a small number of sophisticated investors who often have a prior relationship with each other before. They are, in effect, professional investors. Blank check blind pool companies are vehicles for raising money from the general public.

2. WHAT ABOUT THE ESTABLISHED INVESTMENT BANKING HOUSES, SUCH AS, KOHLBERG, KRAVIS, ROBERTS OR FORSTMANN, LITTLE, THAT SET UP LBO FUNDS IN ORDER TO RAISE CAPITAL TO MAKE FUTURE ACQUISITIONS. HOW DOES THIS DIFFER FROM A BLANK CHECK, BLIND POOL?

(2) Here again, I think that the distinction is that investment banking house situation involves sophisticated investors with a prior relationship, whose profession it is to raise money for such relatively speculative ventures.

3. INSTITUTIONAL INVESTORS, SUCH AS PENSION FUNDS, INSURANCE COMPANIES, AND CORPORATIONS ARE APPARENTLY INVESTORS IN THESE ESTABLISHED CAPITAL RAISING FUNDS, PLAYING A MAJOR ROLE IN PROVIDING GROWTH AND INVESTMENT CAPITAL. IF BLANK CHECK BLIND POOLS WERE BANNED, WHAT WOULD THE IMPACT BE UPON THE VENTURE OR START-UP CAPITAL MARKET?

(3) I do not believe that this would necessarily be the case. However, if it were perceived that proposed legislation potentially impaired the ability of sophisticated investors to band together, perhaps exceptions could be carved out to exempt investors who met relatively high "suitability" standards both from the standpoint of financial resources and financial sophistication.

AS YOU RELATED IN YOUR TESTIMONY, IN THE LAST YEAR THE SEC HAS BEEN WORKING WITH THE SECURITIES INDUSTRY CONFERENCE ON ARBITRATION IN ATTEMPT TO IMPROVE AND ENHANCE ARBITRATION PROCEDURES AND INCREASE THE PUBLIC'S UNDERSTANDING OF THE ARBITRATION PROCESS.

1. AS I UNDERSTAND, IN JUNE OF 1989, THE SROS BEGAN PUBLICIZING BRIEF DESCRIPTIONS OF EACH CASE SETTLED BY ARBITRATION, INCLUDING AMOUNTS CLAIMED AND AWARDED. ARE ALL THE INDUSTRY ARBITRATION PANELS DISCLOSING THIS TYPE OF INFORMATION?

(1) Yes, as far as I can tell.

2. ARE THEY FORCED TO DO SO BY RULE, OR IS IT AT THEIR OWN DISCRETION?

(FOLLOW UP)
MANY CRITICS STILL FEEL THAT FURTHER REFORM IS NEEDED IN AREAS SUCH AS, THE SELECTION OF ARBITRATORS, INFORMATION DISCLOSURE AND DISCOVERY, THE AWARDING OF SETTLEMENTS, AND ADDRESSING THE ISSUE OF THE OVERALL INDEPENDENCE OF THE SYSTEM.

(2) The Arbitrator's Manual directs arbitrators to include the following information in their awards:

(a) the names of the parties;

(b) a summary of the issues in controversy;

(c) the amount of the claim or other relief requested and the amount awarded and against whom the award is made; and

(d) any other matters decided by the arbitrators such as jurisdictional issues.

3. IS THE SEC OR THE SECURITIES INDUSTRY LOOKING INTO ANY OF THESE AREAS?

(3) I do not know about the securities industry, but I believe that the SEC is monitoring the system on an ongoing basis. I know that representatives of the Division of Market Regulation have invited counsel handling arbitration cases to inform the Division of problems which they detect.

4. AS YOU KNOW, NO SYSTEM IS PERFECT. IN WHAT AREAS, IF ANY, DO YOU FEEL THE ARBITRATION SYSTEM NEEDS REFORMING?

(4) There are no clear penalties under the Code of Arbitration Procedure for parties who utilize unprofessional litigation tactics, such as adopting frivolous positions, missing deadlines, and "stone walling" discovery. The federal courts, and many of the state courts, have realized that unless penalties are included within the procedural rules, many litigators will unfortunately use delay and obstruction to their tactical advantage. The Arbitration Rules need to be amended to encourage arbitrators to punish this kind of misconduct, through the use of attorney's fee awards, and, where appropriate, entry of default judgments or similar means. Also, under the current arbitration system, an arbitration panel is not typically appointed until several weeks before the first scheduled hearing. This is something like playing three and a half quarters on an NBA game without a referee. One or more arbitrators ought to be appointed very early in the case, so that they can keep the process moving and handle problems (such as discovery disputes) in a prompt manner.

I also believe that the arbitration system ought to be made more public. There is no reason to exclude the press from arbitration cases, and arbitration pleadings should not be shielded from public view. Brokerage firms are not entitled to have the claims against them decided in secret. In fact, this secrecy disserves this public and contributes to a widespread distrust of the arbitration process.

5. WHAT IS CURRENTLY BEING DONE TO ADDRESS THESE AREAS THAT COULD BE IMPROVED UPON?

(5) The SEC is, as I mentioned, monitoring the process, and appears to be responsive to concerns of public investors. There are, as I understand it, ongoing discussions within the Securities Industry Conference on Arbitration and with the SEC concerning the establishment of a separate arbitration forum.

ACCORDING TO THE SECURITIES INDUSTRY ASSOCIATION ESTIMATES, THE ARBITRATION SYSTEM RUN BY THE SELF-REGULATORY ORGANIZATIONS IS FINANCED BY THE SRO'S THEMSELVES TO THE SUM OF $12-$15 MILLION A YEAR. GIVEN THE FACT THAT THE INDUSTRY FINANCIALLY SUPPORTS AND OPERATES ITS ARBITRATION FORUMS, IT IS NOT SURPRISING TO HEAR CRITICS OF THE ARBITRATION SYSTEM ACCUSE IT OF BEING INHERENTLY BIASED.

1. HOW DO YOU RESPOND TO THESE CRITICS?

(1) I can only relate my experience, and those of my partners, who have spent the past several years handling numerous investor complaints through the arbitration procedures of the various self-regulatory organizations. In general, we have found that the arbitrators who hear these cases are fair and open-minded individuals. In particular, the representatives of the brokerage industry tend to be exemplary individuals who embody the best of the securities profession. Many of these industry arbitrators, particulary some of the older ones who are now retired, hold their profession to a high standard of accountability, and look with disdain upon a lot of the shoddier aspects of the profession, including high pressure sales tactics, churning, and the "sell at any cost" mentality. While I have not won every case that I thought I should have won in arbitration, I could say the same about court. Still, in my experience, most of the time injured investors get a fair hearing and a fair result in arbitration.

2. WHAT RULES OR GUIDELINES ARE IN PLACE TO ASSURE THAT THE INVESTOR WITH A DISPUTE BEFORE AN INDUSTRY RUN ARBITRATION PANEL RECEIVES A FAIR AND UNBIASED HEARING?

(2) The Code of Arbitration Procedure is basically fair. As previously noted, if there are no sanctions for disobeying some of these rules (particulary concerning discovery and deadlines), these rules will be disregarded. I have had a number of experiences in which brokerage firms have simply ignored discovery deadlines, apparently confident in the knowledge that there will be no sanction for noncompliance.

Peterson Story Outline

I. THE CLAIM

A. Failure of Broker to give suitable recommendation. In April of 1987 Dick Juba, a broker for Rauscher Pierce Refnes, recommended and misrepresented to his biggest client, MK Peterson, a complex options trade which he called a "straddle" and a "loss minimizing transaction." This was a broker's dream but a highly risky transaction for the client. It called for the sale of 52,000 naked puts on Sun Co., with a purchase of 52,000 calls on Sun. Peterson was already probably the largest individual holder of Sun stock in Dallas. The recommendation was grossly unsuitable, speculative, was not a straddle and was contrary to Peterson's stated investment objectives in RPR's file - safety of principal and income. Peterson complained immediately but no complaint was filed by Juba, contrary to RPR rules.

(Violates NASD General Suitability Rule, NYSE Rule 405, Rauscher Pierce
Customer Option Agreement
and established fiduciary responsibility of broker to client.)

B. Failure of broker to fully inform client of risk. Peterson had never entered into such a large scale options transaction (had sold puts on 1,000 shares previously, but never anything approaching the magnitude of selling 52,000 naked puts.) Broker did not disclose that:

1. Peterson would incur an immediate margin call for $215,000. In fulfilling this obligation, his lines of credit for additional business transactions were greatly diminished.
2. The recommendation was highly speculative and bullish and contrary to Peterson's stated investment objective.
3. Peterson would have cornered the market on Sun puts, making it virtually impossible to cover them without incurring a huge loss on the "buy in."

(Violates securities regulations and fiduciary responsibility)

C. Failure of broker to execute a direct order. Juba, Peterson's longtime broker and close personal friend, was given a direct order to cover the puts on Sept. 23, 24 and 25 prior to Peterson's leaving to attend to his timber interests in the woods of Northern Michigan where he would have no access to a phone during business hours. Juba stalled, but finally recommended covering when the price of Sun reached 62-63. This, too, was unsuitable. The price did reach 62-63+ for several days; Juba did not execute order. He later said he was waiting for stock to gain another 1/8 point (worth about $6000). His failure to execute risked over $3,000,000 and **has ultimately cost Peterson close to $2,000,000 in losses and attendant costs.**

(Violates Breach of Contract law and
Rauscher Pierce Company Manual regulations.)

more...

Peterson, page 2

II. THE ISSUES

A. Liability of Brokerage Firm

1. According to RPR company regulations, all large options transactions must be monitored by management and require branch management to verify trade with client prior to transaction. Although the assistant manager called this trade to his manager's attention, manager failed to contact Peterson, nor did other supervisory staff question this very large and unusual trade as required by their own regulations.

2. RPR company regulations call for all complaints reported to brokers by clients to be filed with branch management by broker. Peterson complained immediately in April upon the margin call and continued to complain all summer. None of Peterson's complaints were filed with management by Juba. In front of a witness on Oct. 14,1987, Juba asked Peterson to withdraw the formal complaint contained in Peterson's certified letter of Oct. 12, 1987. Peterson refused to do so.

3. The broker did not execute Peterson's specific order to cover the puts given on September 23, 1987. Juba's recommendation was to wait until the price of Sun reached 62-63. Although Peterson agreed, Juba did not act upon that order in his absence. Peterson returned from his trip late on Oct. 6 and learned that Juba had not executed the order. He complained immediately and vociferously on Oct. 7, 1987 (8 AM) and advised Juba that he held him and his firm responsible for any losses resulting from his failure to execute. RPR did nothing.

4. When Rauscher Pierce management did finally meet with Peterson on October 16, 1987, they blamed him for being in the position that he was, i.e., they accepted no responsibility for themselves or their broker in the matter, despite Peterson's well-documented prior complaints. On October 19, 1987, Peterson's fears and complaints of the previous six months were validated by his huge loss.

B. Compulsory arbitration was not mandated in this case, according to Peterson's options agreement with Rauscher Pierce, which could not be obtained from RP until after arbitration had begun. Peterson never wanted arbitration in the first place, fearing that all he had heard and read would turn out to be true - that the procedure is lengthy, biased, and a "stacked deck" against the investor. The SEC and NASD have stated that large, complex cases (such as this) are not suited to arbitration. It is very difficult to have an arbitration decision overturned by the courts, yet the court refused to even hear the case until arbitration was complete.

C. Delays. Multiple delays and sporadic hearings in the two years, three months since October, 1987 have resulted in only 7 1/2 days of arbitration hearings during this time. A minimum of 6 additional days will be required for Peterson's attorney to present the case. Having had one arbitrator declare at the last hearing that he will only be available one day at a time for this case, assuming the optimum of a hearing each month (which has never happened) the case will take a minimum of six more hearings. Despite the promise of a swift, fair, relatively inexpensive process, as Peterson was assured by the NYSE it would be, the lengthiness of the arbitration procedure has cost Peterson over $300,000 in

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legal fees. Interest on the money lost continues to mount at the rate of almost $600 per day. And due to the prolonged stress Peterson, a 70 year old man, has developed heart problems. Hearings held sometimes 90 days apart necessitate Peterson's attorney having to prepare the case each time almost all over again, causing unecessary duplication of expense.

D. Arbitrator Bias. There is dramatic, repeated, documented evidence of arbitrator hostility and bias, as well as lack of knowledge on complex options transactions, beginning from the first day of hearings. Arbitrators have made such statements as "Mr. Peterson, I don't like your personality," "He's a speculator,"(*made by 4 of the panel members on the first day* - and a charge which Peterson's record disproves) and "It is your responsibility if your broker does not follow your orders." On this basis, not only has Peterson's attorney repeatedly appealed to NYSE to have the arbitrators step down but the former head of arbitration of the American Stock Exchange, after analyzing the hearings' transcripts, stated that the lack of knowledge and obvious bias and hostility of arbitrators necessitated their removal.

III. THE COVER-UP (or coincidences???)

A. Rauscher Pierce.

1. From the first meeting with Peterson on October 16, 1987, RPR management has attempted to shift blame to Peterson for his situation. When asked early on to provide all documents relating to Peterson to his attorney, multiple delays in sending the required information resulted in the most important document of all - Peterson's own options agreement - *not arriving until after arbitration had commenced.* Had Peterson had this agreement, which does not mandate arbitration as Peterson was led to believe, in due time his case would have been heard in court, where duly established rules of justice would have allowed it to be fairly heard.

2. There is ample documentation that Juba did not execute his client's order (Juba initially admitted this in front of a witness and in his own deposition) and that the recommendation for this trade was unsuitable in the first place. Now Juba and the attorney for Rauscher Pierce, Bruce Collins, have changed their story. Not only do they allege that Peterson never gave the order but they refer to a new strategy that they refer to as "net credit." They also allege that Peterson himself is causing the delays. Again, ample documentation exists that the delays, except for the one instance when Peterson's attorney filed a court petition to remove the case from arbitration, have never been caused by Peterson. In fact, numerous letters from both Peterson and his attorney dating back to March of 1988 have consistently implored the Exchange for a swift hearing process.

3. Rauscher Pierce now alleges that Peterson: is causing the delays, has been in prior arbitration, wanted arbitration at first and then wanted out when it was obviously slanted against him, should have known the risks without Juba's pointing them out, and is savvy enough that he would have overridden his broker's reluctance to cover the puts if that's what he had wanted. Ample documentation exists to disprove each of these claims. It has also been alleged that Juba would, if given any kind of order, have executed it to gain the commission. This theory overlooks one important factor: Juba knew that his client, who unknowingly had cornered the market on Sun Oil puts, did not realize that he would

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incur tremendous losses in covering the puts. This was his single largest client, whom he risked losing if the truth became known. On the other hand, if Peterson could be persuaded to allow the puts to expire in Nov., he would never realize the risk that his broker had exposed him to. Juba, like most brokers, could not have foreseen the events of October 19, 1987.

4. Collins, the RP atty, has made an issue out of Peterson's hiring a publicist, writing letters to Congress, contacting every possible securities regulatory body and requesting media presence at his hearings, which was not permitted. What did the arbitrators have to hide? It would seem the defense alleges that an individual has no right to assert his rights in the matter of a well - founded claim being obscured by the pitfalls of arbitration. Rauscher Pierce, by the way, has every right to do so, including the use of their own public relations department.

B. The New York Stock Exchange

1. The Exchange has been asked repeatedly to investigate the obvious bias and hostility of the arbitrators. Further, they've been twice asked by Peterson's attorney to order the arbitrators to recuse themselves. An in-depth investigation by the former head of the American Stock Exchange, David Robbins, (considered the leading expert on arbitration in this country), calls for the arbitrators to step down immediately. The exchange has consistently ignored these requests.

2. As previously pointed out, the SEC asked the NYSE to investigate arbitrator conduct in this proceeding. The NYSE refused, on the basis that Peterson had filed a lawsuit against it for its mishandling of the arbitration process in general. Although the lawsuit and the conduct of the arbitrators are separate issues, the NYSE excuse was apparently good enough for the SEC.

3. Requests directed to the NYSE to allow media presence in the arbitration hearings of this major claim (one of the largest in the country) have been denied. Yet Morris, head of arbitration at the exchange, is quoted in an interview in March of '88 (*Houston Post*) as calling for more public information on arbitration.

4. The Exchange steadfastly reports that arbitration is a swift, fair and relatively inexpensive process in which more than 50% of the investors receive some kind of settlement of their claim. Yet the Exchange will not release specific information, such as a list of all arbitration claims over the past three years, the claim amounts, the issues and what, if any, settlement was made. Unlike the courts, arbitration proceedings are not a matter of public record. Yet Exchange rules are such that arbitrators are not bound by rules of law, have absolute power, and do not have to give any reason whatsoever for their ultimate decisions. Neither trained as jurists or lawyers, these laymen hold the claimant's fate in their hands.

C. The Securities and Exchange Commission. In early 1989, the SEC was asked by Congressman John Dingell (D, Michigan) to investigate the way in which the NYSE was handling this case. The SEC wrote a letter requesting information. NYSE stonewalled, citing pending litigation, and the SEC abruptly dropped the matter. The SEC did not force the issue. Who is the oversight body?

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D. Texas State Securities Board. This body initially began an investigation of the arbitration of this case, but suddenly dropped all interest without explanation.

E. Congress. Peterson was invited to testify before a Senate committee hearing investigating the arbitration process to be scheduled sometime during 1989. The matter was suddenly dropped. Rumor has it that a significant contribution from the securities industry was awarded to at least one member of the investigation committee.

F. State Court of Texas. The court was petitioned in October, '88, after options agreement received by Peterson's atty. revealed that arbitration was not mandated by his agreement. Perhaps unaware of the fact that Peterson had landed in arbitration before his agreement could be obtained from RPR, the court refused to hear the case until arbitration is completed. This was a particularly harsh ruling, forcing Peterson to go through the lengthy and expensive arbitration process and later have to duplicate the expense to appeal to court. However, the right of appeal to the court of an arbitration decision is very difficult.

G. Texas media. The case has been reported in *Barron's* (June,'89)and over the AP wire(Jan,'90). Numerous out of state newspapers, including the *Chicago Tribune*, have included it in their stories about arbitration. Peterson has received calls from all over the country from investors who have suffered similar plights at the hands of arbitrators. Yet not one Texas newspaper picked up the story (RP is a regional firm based in Dallas.) One major Dallas paper has interviewed Peterson three times, each time suddenly dropping the story. Dallas' foremost business journal also interviewed Peterson, later dropping the story abruptly. Both had evinced extreme interest until they took their stories back to their editors. Suddenly there were numerous"reasons" why they could not print anything. How strange that Chicago is interested and Dallas is not, since Peterson is a prominent and respected Dallasite.

H. The arbitrators.

They refuse to allot the time out of their schedules to hear the case in its entirety in an expeditious manner, would not listen to a summary of the case, cannot meet more than one or two days in succession at a time, cannot seem to even manage to meet on a monthly - or regular - basis. From day one, they were hostile to Peterson. They are enraged by the request for media presence. They do not seem to understand the complexity of the transaction. They obviously do not like Peterson. Yet they refuse to step down. With so little interest, knowledge or time, what keeps these five arbitrators so determined to serve on this particular panel?

Documentation of above outline is contained in numerous affidavits, letters, the actual transcripts and eyewitness statements. For documentation or more information, contact David Wilkinson or Ellen Cornell at (214) 739-3564.

RESPONSE TO WRITTEN QUESTIONS FROM SENATOR DODD TO FRANK J. WILSON, GENERAL COUNSEL AND EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Legitimacy of the Penny Stock Market

According to the September 1989 report by the State Securities Administrators (NASAA) on the penny stock market, total annual primary and secondary market activity is estimated to be $10 billion, with American investors losing at least $2 billion each year as a result of fraudulent offerings and schemes.

Question: In your view, is there actually a legitimate penny stock market? From conversations with the staff, it seems that the SEC, the NASD, and the state regulators had great difficulty identifying with a clean, small capitalization penny stock broker-dealer.

Answer: For the purposes of responding to your questions regarding the penny stock market, we refer to a generally accepted definition contained in the SEC publication, Information for Investors: Beware of Penny Stock Fraud!. That definition refers to penny stock as those that are "low priced (usually trading under $3 per share) and, with few exceptions, are not traded on an exchange or quoted on NASDAQ." Others refer to penny stocks as those trading under $1.00.

The over-the-counter market differs from exchange markets in that the exchanges use an open outcry auction market centralized by a single specialist for each security, while the over-the counter market is composed of competitive dealers, often representing clients, to compete with one another for order flow based upon the best price, which, in the case of the National Association of Securities Dealers Automated Quotation System (NASDAQ), is centralized through computerization.

Two of the three segments of the over-the-counter market are parts of the highly computerized and closely monitored NASDAQ. The NASDAQ market, which lists companies such as MCI, Apple, and Toyota, is divided into two segments: the National Market System (NMS) and the regular NASDAQ market. The third segment of the over-the-counter market is the Non-NASDAQ over-the-counter market (NNOTC), which is often referred to as the "pink sheet" market, a name derived from the color of the pages on which its quotations are listed. Unfortunately, our research indicates that the public and others often erroneously equate "over-the-counter" with all non-exchange markets, including NASDAQ and NNOTC, in spite of the significant listing, regulatory, and operational differences that distinguish the NASDAQ over-the-counter markets from the pink sheet markets.

It is important to understand that there are significant differences between the NASDAQ market and the NNOTC market. The NASDAQ market is a screen-based system that reflects up-to-the-second price information of all market makers in a particular stock.

There is no such quotation system for NNOTC issues. Because NASDAQ is an electronic trading and quotations system, the NASD, through its computers, is able to reconstruct movement in the market that appears questionable. Quotations, volume, and transaction information are all readily accessible to the investing public as well as to the NASD as a regulatory agency. Likewise, as discussed below, issuer information is readily accessible about NASDAQ companies, which often have significant analyst followings that provide current analyses and recommendations. On the other hand, many of the companies in the NNOTC over-the-counter market have very little, if any, information available about their earnings, business operations, prospects, etc. In a similar vein, current and reliable price and volume information relative to trading in these NNOTC securities is in many instances non-existent. There are thus broad differences between the NASDAQ market and the NNOTC, differences that stem from visibility, computerized regulation, accessibility and reliable price and volume information and automated surveillance programs.

The NASD is unaware of any data that quantifies "legitimate" activity in penny stocks from "illegitimate" activity. As a result, it is impossible to definitively assess the legitimacy of the penny stock market. However, we believe there is some legitimate trading of low priced stocks among professional dealers and legitimate retailing of those penny stocks to investors.

Question: Do such clean and legitimate penny stock broker-dealers exist?

Answer: The NASD believes that there are some broker-dealers who conduct themselves honestly in acting as a market maker for small, start-up companies with limited resources whose securities are low priced. These broker-dealers are market makers in securities of small companies with a business plan and management in place who need access to the markets for the infusion of capital.

Question: Is there a real demand for penny stocks? Outside of the small investors that are obviously being ripped off, what kind of interest is there for this type of security?

Answer: We believe that investors have, and will likely continue, to demand access to low-priced stocks. The capitalist philosophy of our nation encourages entrepreneurial expression through business development. We must recognize that many legitimate business ventures raise capital through the sale of low-priced stocks and that there are investors who want to invest in those companies hoping that they will be on the ground floor of another Apple Computer. The NASD strongly believes that aggressive regulation is the best way to ensure investor protection against illegitimate stock offerings and those unscrupulous individuals that intend to defraud unsuspecting investors. Through vigorous enforcement measures, the NASD has targeted problems in the penny stock market. We are pleased to note that the number of penny stock complaints made to the NASD by customers and others dropped 75% in the last year.

Likewise, it would be naive to believe that the proliferation of penny stocks is strictly the result of investor demand for ownership in legitimate start-up companies. Aggressive sales tactics frequently play a major role in the sale of penny stocks and the NASD has repeatedly taken enforcement actions to address this abuse. Several of these actions were the result of coordination with other agencies also battling securities fraud. In fact, the NASD is presently engaged in a number of joint investigations with the SEC, the FBI, U.S. attorneys, the IRS, State Securities Commissioners, State Attorneys General, and others on both the civil and criminal side to fight stock abuse in pink sheet securities. Also, the NASD believes that the SEC's Rule 15c2-6 (Penny Stock Rule) will provide significant protection with respect to the suitability of recommendations of low-priced stocks to customers, and be a strong deterrent to the unscrupulous cold calling campaigns that create demand for penny stocks.

Question: As you know, some states have implemented merit regulation securities laws. In contrast to the federal "disclosure" standard, merit statutes require that the securities administrator make a finding that the offering is fair, just and equitable. For example, California does not allow penny stock initial public offerings if the issue has less than a $2 selling price.

If this were implemented nationwide, who would be harmed?

Answer: If initial public offerings under $2 per share were prohibited nationwide, many legitimate small, start-up companies would be seriously impacted as they would have to look to other sources to raise capital, thus harming their capital raising capabilities. Under those circumstances, the company might be able to sell its securities through private placement transactions to sophisticated investors or to venture capital firms. In this scenario, the small start-up company will have a much smaller base from which to turn for its capital needs, thus impacting negatively the entire capital formation process.

Question: What do you see as the redeeming and beneficial aspects of the penny stock market?

Answer: Capital formation for small, start-up companies with limited resources that have management and a real product and are operating according to a business plan.

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RESPONSE TO WRITTEN QUESTIONS FROM SENATOR HEINZ TO FRANK J. WILSON, GENERAL COUNSEL AND EXECUTIVE VICE PRESIDENT NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Legitimacy of the Penny Stock Market

Question: Whether civil remedies are a sufficient deterrent to penny stock fraud?

Answer: The civil remedies available to securities regulators, while significant and effective, can not alone be a deterrent against the type of fraudulent abuses we have seen in the penny stock market based on the NASD's enforcement efforts to date. Oftentimes, the individuals involved in this misconduct have already been barred by securities regulators. In addition, fraudulent activities are at times criminal in nature and in these most egregious cases, criminal prosecution must be utilized as a complement to the civil and regulatory actions taken by securities regulators. Regulation of penny stock fraud should combine criminal prosecution with civil and regulatory enforcement in order to be a sufficient deterrent to fraud and misconduct.

Question: Does the NASD, as a matter of course, make an immediate referral to appropriate criminal authorities when it begins an investigation of penny stock fraud which also appears to involve criminal conduct? If not, why not? What is the NASD's policy with respect to criminal referrals? If so, what is the typical reaction of the criminal enforcement authorities? Do the civil and criminal authorities then work together to bring a case?

Answer: As stated in the Cooperative Enforcement of Federal and State Securities Laws and NASD Rules, the NASD policy is to expedite referral of apparent instances of misappropriation, conversion, or embezzlement perpetrated by an associated person to state and/or federal authorities, as appropriate, for criminal prosecution. When an NASD District Office uncovers such a violation, its staff will investigate sufficiently to substantiate the occurrence of the violation and the likelihood that the associated person committed it.

If, based on the evidence, the NASD investigators determine there is reasonable cause to believe that a violation has occurred, they will inform the District Director. If the District Director agrees with the staff's findings, he will immediately refer the matter to the appropriate federal or state authorities.

With regard to "immediate referral to appropriate criminal authorities when the NASD begins an investigation of penny stock fraud which also appears to involve criminal conduct," the NASD follows the policy stated above if the alleged criminal conduct involves misappropriation, conversion or embezzlement. If the investigation uncovers other criminal activity, the NASD does not, as a matter of course, make an "immediate" referral to criminal authorities because at the beginning of an investigation, the likelihood that a violation exists that is egregious or willful enough to warrant a criminal referral is not known. If our investigation does uncover willful or wanton misconduct that we believe would interest federal or state prosecutors, an immediate referral is made by the NASD. Also, as a self-regulatory organization (SRO), the NASD's jurisdictional boundaries are limited to our member firms and their associated persons. We are not able to compel information from non-registered entities or individuals that are not associated with NASD members.

The NASD is committed to working with other agencies against securities fraud. In fact, in addition to actions taken on its own, the NASD is also engaged in a number of joint investigations with the SEC, the FBI, U.S. Attorneys, the IRS, State Securities Commissions, State Attorneys General, and others on both the civil and criminal side to fight stock abuse in pink sheet securities, for example. The NASD also has specifically assigned senior enforcement staff on a full-time basis to prosecutors' offices to assist in other criminal investigations involving suspected penny stock fraud. By working with the U.S. Attorney's Offices on cases that the NASD uncovers, as well as assisting the U.S. Attorneys on cases they initiate, the NASD is able to combine its expertise in the securities markets with the powerful investigative tools of subpoena and wiretap available to federal prosecutors.

Recent examples of cooperation between the NASD and criminal authorities include the case against Eugene Laff, the former chairman and president of Haas Securities. Haas was recently convicted after a lengthy federal trial in the Southern District of New York. We also assisted in the investigation of criminal misconduct of F.D. Roberts and its associated persons, many of whom recently pled guilty to securities fraud. In late April 1990, the New Jersey U.S. Attorney announced that several individuals, including two officers of Sheffield Securities, a defunct Florida-based penny stock firm, pled guilty to federal conspiracy charges in connection with the manipulation of three over-the-counter securities. The NASD worked very closely with the U.S. Attorneys offices through the investigation by providing documentation, trading and transaction information, technical, and legal assistance unique to manipulation cases throughout the preparation of these cases.

Question: What kind of sanction is typically imposed on the brokers who participate in a boiler room shop stock manipulation scheme?

Answer: Broker-dealers and associated persons who are found to have participated in boiler room tactics and fraud are considered to have engaged in egregious conduct that results typically in serious sanctions being imposed. These can include expulsion or suspension of the firm from NASD membership, barring or suspending an individual from being associated with an NASD member, requiring restitution, and the imposition of finds and costs.

Question: When the NASD suspends an individual from the securities business, whether temporarily or permanently, how is the regulator able to ascertain whether the sanction has been complied with? Does the NASD advise its member broker-dealers of all persons suspended or barred from the industry by itself, the SEC, or state regulators? What sanctions are available (and imposed) against broker-dealers which employ suspended or barred persons? Is the firm's registration revoked?

Answer: In certain instances, the NASD requires individuals who have been suspended to file with the NASD an affidavit of compliance at the end of their suspension period. In other cases, the broker-dealer's records are checked through our routine examination or special cause inspection programs to determine whether the suspended individual has continued to receive compensation from the firm, which is prohibited.

The NASD does advise its member firms of all firms and individuals that have been the subject of final NASD disciplinary action that results in sanctions of expulsion, suspension, bar, or monetary fines of $10,000 or more. The information provided to member firms in the monthly publication titled "Notice to Members" includes the nature of the violation, the sanction imposed, the dates the sanction is in effect and any appeal process which has been pursued by the violator. Unless it is the result of a joint cooperative investigation with the NASD, the Association does not advise its members of persons suspended or barred by other regulatory bodies, including the SEC and states.

Sanctions available for broker-dealers that employ suspended or barred persons that are statutorily disqualified from being in the securities business include: censures, suspensions, expulsions and fines. The regulatory framework allows a new employer to apply to the NASD, or other SRO, for approval to employ individuals that have been statutorily disqualified. Such a member would be the subject of a hearing to determine the permissibility of allowing a disqualified person back into the securities business. It would be unusual to revoke the firm's membership for employing an individual that is subject to NASD sanctions; however, the penalties to the firm are commensurate with their willfulness and knowledge of the NASD sanctions against the agent.

A recent example of NASD action was in the case of K. A. Knapp and Co., Inc., et al. It was determined that the firm employed an individual who had been barred from association with an NASD member firm as a principal. Both the firm and its principal were found liable for employing an individual in contravention of an NASD suspension. The firm was expelled and fined $50,000 and the principal was barred and fined $100,000.

Another recent example involves Wellshire Securities, Inc., a penny stock broker-dealer, and two of its registered principals and control persons, both of whom had become subject to a statutory disqualification while registered with the NASD. Following a hearing, an NASD panel concluded that the NASD membership of Wellshire Securities be canceled effective immediately.

Question: Does the NASD have the authority to bar persons from serving as consultants or advisers to broker-dealers? If not, does the NASD have the authority to sanction a broker-dealer firm which uses the services of a person which has been suspended or barred?

Answer: Infrequently -- but still too often -- we see individuals that we have taken enforcement actions against and barred from further association with NASD members returning in the role of consultant, adviser or promoter. Unless proved otherwise, these individuals fall outside the scope of SRO regulatory jurisdiction. However, if it is determined that the relationship is such that the consultant or advisor could be defined as an "associated person" of an NASD member, the NASD would then have the authority to sanction that person with censures, suspensions, bars or fines. Interestingly, one of the recommendations in the NASD's Final Report of the Regulatory Review Task Force published in March 1988, was to obviate the use of "consultant" status to evade the impact of a bar or suspension, and a similar provision is included both in S.2057, the Small Investor Protection Act of 1990 and HR 4497, the Penny Stock Reform Act of 1990.

Further, if the person has been previously barred, and we find that he has become an associated person of an NASD member, not only can the NASD bring disciplinary action against the individual, but also against the member for its misconduct.

Question: In your view, are the Justice Department and state law enforcement authorities devoting sufficient resources to this problem? What more should they be doing?

Answer: It is our experience in the last two years that the NASD has been actively working with state and federal law enforcement agencies, the Justice Department has devoted more resources to securities fraud cases and is more receptive to considering securities cases for criminal prosecution. In fact, under Attorney General Thornburg, certain U.S. Attorneys' Offices have augmented their staff working with these cases.

The states must also be commended for attempting to address the plethora of cases confronting them. Unfortunately, the severe budget problems facing the majority of states negatively impact the resources that can be devoted to securities fraud cases. It must be recognized that these are often very often time consuming, complex and sophisticated cases that may be very difficult to prove. One does not find a "smoking gun" in a boiler room scam, for example.

Also, in both the federal and state arenas, a multitude of agencies must compete to capture the attention of the criminal prosecutors. Enforcement punishes wrongdoing after it occurs and serves as a deterrent to prevent others from attempting the same illegal behavior. While meaningful disciplinary actions are an essential part of any regulatory plan, they must be combined with improved systems if prevention of fraud is to be effective. For this reason, the NASD is very proud of its Anti-Fraud Department and array of prevention programs designed to detect and prevent wrongdoing before it becomes an issue to be addressed by enforcement.

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MANUFACTURING
CREATES
AMERICA'S
STRENGTH

STATEMENT

of the

NATIONAL ASSOCIATION OF MANUFACTURERS

On S. 647

Submitted to the

U.S. SENATE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
SUBCOMMITTEE ON SECURITIES

February 9, 1990

NAM

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The National Association of Manufacturers is a voluntary business association of more than 13,500 member companies and subsidiaries, large and small, located in every state. Members range in size from the very large to the more than 9,000 smaller manufacturing firms, each with fewer than 500 employees. NAM member companies employ 85 percent of all workers in manufacturing and produce more than 80 percent of the nation's manufactured goods. NAM is affiliated with an additional 158,000 businesses through its Associations Council and the National Industrial Council.

SECURITIES LAW ENFORCEMENT REMEDIES ACT OF 1989

EXECUTIVE SUMMARY

The National Association of Manufacturers (NAM) supports the congressional intent behind S. 647, but opposes the bill in its current form.

In light of the extensive remedies currently available for addressing willful violations, NAM submits that the additional civil remedies for such violations as proposed in S. 647 are unnecessary. Under current law, the SEC can address willful violations by investigating and seeking criminal penalties and imprisonment, by imposing cease and desist orders in administrative proceedings, by seeking injunctions in federal court and by suspending or revoking registrations. Such remedies are sufficient to enforce and deter willful violations.

For minor securities violations, NAM recommends alternative revisions to current law that would empower the SEC to administratively impose fines of up to $100 per day against officers and directors of corporations. This remedy would allow the SEC to enforce and deter minor filing violations.

NAM strongly opposes empowering the SEC with authority to remove officers and directors from registered corporations through judicial and administrative proceedings. NAM recommends clarifying current law to provide statutory authority for the SEC to do what it already is doing, i.e., seeking removal from office as part of a voluntary settlement of proceedings. Such clarification of law would eliminate current uncertainties. However, the extension of this remedy from consent decree to administrative or court decrees is unnecessary, unwarranted and detrimental to traditional principles of corporate governance.

STATEMENT
OF THE
NATIONAL ASSOCIATION OF MANUFACTURERS
On S. 647
SUBMITTED TO THE
U.S. SENATE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
SUBCOMMITTEE ON SECURITIES
FEBRUARY 9, 1990

The National Association of Manufacturers appreciates this opportunity to submit a statement commenting on S. 647, the Securities Law Enforcement Remedies Act of 1989.

NAM has been on public record throughout the 1980s urging better enforcement of securities laws by the Securities and Exchange Commission to curtail insider trading violations. Nevertheless, NAM opposes S. 647 in its current form and recommends that this legislation be revised to eliminate additional remedies for willful violations already addressed by current enforcement remedies. For minor securities violations, NAM recommends alternative remedies to allow the SEC to impose civil fines on officers and directors in administrative actions.

I. ADDITIONAL CIVIL REMEDIES FOR WILLFUL VIOLATIONS OF SECURITIES VIOLATIONS ARE UNNECESSARY.

S. 647 authorizes the SEC to request courts to impose a civil penalty as high as $100,000 for individuals or $500,000 for corporations (or the amount gained by the offense, if it is greater) upon a finding of a violation of the federal securities laws. In Sec. 15(c)(4) administrative proceedings, the SEC would also be authorized to impose civil penalties of up to $100,000 for a natural person or up to $500,000 for a corporation for failure to comply with periodic reporting requirements of the Securities Exchange Act of 1934 or Sec. 16(a) (reporting short-swing transactions).

NAM strongly questions the necessity of these additional remedies for willful violations in light of alternative remedies currently available. Under criminal sanctions of willful violations, officers and directors can be fined up to $10,000 and be imprisoned up to five years (Sec. 24). For willful violation by natural persons of the Exchange Act, as amended in 1988, or regulations pursuant to it (except the Foreign Corrupt Practices Act), fines can be imposed up to $1,000,000 and imprisonment given up to 10 years. For persons, other than natural persons, fines can be imposed for up to $2,500,000 (Sec. 32). The amount of these fines is within discretion of the federal court.

In administrative proceedings, the SEC already has extensive remedies to address willful violations. The authority of the SEC to order registered companies to comply with the statute was extended recently to cover individuals by the Insider Trading Sanctions Act of 1984. Therefore, Sec. 15(c)(4) of the Exchange Act now permits the SEC to order any registered company that violates the registration and reporting provisions, and any persons who cause such violations, to be subject to an order to comply with the law. These orders have been recognized by the SEC as the equivalent of cease and desist orders.

Under the Securities Act, the SEC also may, after notice, issue a stop order suspending the effectiveness of a registration under the Act (Sec. 8(d)) or, without notice, issue an order preventing or suspending the use of a prospectus if the commission finds that the document is not in compliance with the statute and SEC regulations (Sec. 10(b)). The SEC also may, after notice, suspend or revoke a registration under Sec. 12(j) of the Exchange Act if the SEC finds that the issuer has failed to comply with any of the provisions of that Act or regulations made by the SEC under the Act. Effectively, of course, this terminates the ability of the issuer to sell his securities in the public market and may provide a basis for private actions.

The power authorized to the SEC to investigate securities violations also has a significant impact on enforcement and deterrence. The SEC is authorized to investigate possible violations of the statutes or the regulations under them and to require the disclosure of books and records and to subpoena witnesses in connection with such investigations. (Section 20(a) and 19(b) of the Securities Act and Secs. 21(a) and (b) of the Exchange Act.)

The SEC also may publish its findings concerning any violation (Sec. 21(a) of the Exchange Act) and such publications may provide, and frequently have provided, the basis for administrative proceedings or private actions requiring the disgorgement of profits or, for certain violations involving insider trading under the 1988 amendments of the Exchange Act, treble damages.

Injunction also is a powerful remedy available to the SEC. Both the Securities Act (Sec. 20(b)) and the Exchange Act (Sec. 21(d)) authorize the SEC to bring an action in federal courts to enjoin any person from violating the statutes or regulations under them (or rules of national securities exchanges) even if no violation has yet occurred and the SEC only believes that the person is "about to engage in acts or practices constituting a violation..."

In light of the extensive remedies currently available for addressing willful violations, NAM submits that the additional civil remedies for such violations as proposed in S. 647 are unnecessary.

II. CURRENT LAW SHOULD BE CLARIFIED TO ALLOW THE SEC TO IMPOSE CIVIL FINES ON OFFICERS AND DIRECTORS FOR MINOR INSIDER TRADING VIOLATIONS.

Empowering the SEC with the blanket authority to administratively impose fines up to $100,000 for natural persons or $500,000 for corporations is both unnecessary and inappropriate for the deterrence of minor filing violations. NAM strongly opposes the authorization of such broad civil remedies.

NAM recommends alternative revisions to current law that would authorize the SEC to enforce minor filing violations. Section 32(b) of the Exchange Act provides that any issuer who fails to file reports required under Section 15(d) (that is, the periodic reports such as the Forms 10-Q and 10-K reports) "shall forfeit to the United States the sum of $100 for each and every day such failure to file shall continue." The forfeiture is expressly stated to be "in lieu of any criminal penalty." Because the SEC is not authorized to litigate in the name of the United States, it has not sought to enforce this provision and neither has the Department of Justice.

To improve this area of enforcement, the NAM recommends the following alternative proposals:

A. Clarify the authority of the SEC to impose the sanction now provided in Section 32(b) of $100 per day for failure to file periodic reports.

This reform would authorize the SEC to impose such fines in administrative proceedings in connection with the authority to issue cease and desist orders as suggested by the Report of the National Commission on Fraudulent Financial Reporting (Treadway Commission Report) in 1987.

B. Extend the $100 per day fine under Section 32(b) to directors, officers and 10 percent beneficial owners who fail to file Section 16(a) reports as required under the Exchange Act.

The imposition of the fine should be limited to failure to report purchases and sales within the meaning of Section 16(b) rather than failure to report any acquisitions or dispositions as Sec. 16(a) requires. This would exempt from fines inadvertent disclosure violations of gifts and inheritances.

Alternatively, Section 32(b) of the Exchange Act could be rescinded and the $100 per day fine substituted for the proposed civil penalties in S. 647, with the limitations already proposed.

III. CLARIFY THE SEC'S CURRENT AUTHORITY TO REMOVE OFFICERS AND DIRECTORS BY CONSENT DECREES.

NAM strongly opposes the proposal in S. 647 that would allow the SEC to take action in judicial and administrative proceedings to remove directors and officers from the management of registered companies.

The SEC has already succeeded in making removal from office a condition for the granting of consent decrees in federal courts in a number of cases. It may be appropriate to provide statutory authority (and limitations) for the SEC to do what it already is doing, i.e., seeking removal from office as part of a voluntary settlement of proceedings. Such clarification of law would eliminate current uncertainties. However, the extension of this remedy from consent decree to administrative or court decrees is unnecessary, unwarranted and detrimental to traditional principles of corporate governance.

The appointment and removal of directors and officers is one of the principal functions of corporate governance that traditionally has been reserved to the states. This power has been exercised through provisions in state corporation laws authorizing the shareholders, in the case of directors, or the directors, in the case of officers, to remove such persons from office.

IV. CONCLUSION

NAM supports the congressional intent behind S. 647, but opposes this legislation in its current form.

In light of the extensive remedies currently available for addressing willful violations, NAM submits that the additional civil remedies for such violations as proposed in S. 647 are unnecessary. Under current law, the SEC can address willful violations by investigating and seeking criminal penalties and imprisonment, by imposing cease and desist orders in administrative proceedings, by seeking injunctions in federal court and by suspending or revoking registrations. Such remedies are sufficient to enforce and deter willful violations.

For minor securities violations, NAM recommends alternative revisions to current law that would empower the SEC to administratively impose fines of up to $100 per day against officers and directors of corporations. This remedy would allow the SEC to enforce and deter minor filing violations.

NAM strongly opposes empowering the SEC with authority to remove officers and directors from registered corporations through judicial and administrative proceedings. NAM recommends clarifying current law to provide statutory authority for the SEC to do what it already is doing, i.e., seeking removal from office as part of a voluntary settlement of proceedings. Such clarification of law would eliminate current uncertainties. However, the extension of this remedy from consent decree to administrative or court decrees is unnecessary, unwarranted and detrimental to traditional principles of corporate governance.

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Member:
National Association of Securities Dealers
Securities Investor Protection Corporation

February 8, 1990

Hon. Christopher Dodd, Chairman
Securities Subcommittee
Senate Banking Committee
Room 534
Dirksen Senate Office Building
Washington DC 20510

Dear Senator Dodd:

I understand that the Subcommittee has scheduled hearings today on the widespread practice of the securities industry to require customers to sign predispute arbitration agreements, and the problems of small investors faced with such agreements. This firm would like to comment upon this subject, and we respectfully request that our comments be placed in the record. We also would appreciate a copy of the Subcommittee hearings when the record is printed.

We are a small firm of two partners and four employees. Nonetheless, we collectively represent more than 40 years of experience in the securities industry. We are a member firm of the National Association of Securities Dealers, Inc. and the Securities Investor Protection Corporation. We are not members of the Securities Industry Association. We have been in business since 1981, when our revenues totaled $31,000 and our firm consisted of just the two partners; our revenues for 1989 were $1.2 million. We have never had any disciplinary action taken against us or an employee by any regulatory organization. We have had two arbitrations brought by public customers in nine years, during which we have handled more than 50,000 securities transactions. We feel justifiably proud of this record. We do not require arbitration as a condition of doing business with us.

As the Subcommittee is aware, the Supreme Court has held that predispute arbitration agreements between securities firms and customers are enforceable under the Federal Arbitration Act [9 USC 1 et seq.] Shearson/American Express v. McMahon, 482 US 220, 107 S. Ct. 2332, 96 L.Ed.2d 185 (1987). The nature and purpose of arbitration is to obtain an expeditious, efficient and definitive resolution of controversies. The existence and powers of the arbitrators arise out of the contract, and a federal court may not review an arbitration award de novo, Livingston v. Nestle-LeMur Co., 607 F.Supp.1337, 1340 (S.D.N.Y. 1985). Rather, a court should show deference to the intent of Congress in establishing a federal arbitration policy with respect to the findings, interpretations and award of the arbitrators, even if the

"We speak your language"

results reached are not results with which the court might necessarily agree. See, eg., United Paperworkers International Uniion v. Misco, Inc., 484 US 29, 108 S.Ct. 364, 98 L.Ed.2d 286 (1987); United States Steel and Carnegie Pension Fund v. Dickinson, 753 F.2d 250 (2d Cir.1985).

It is a fact that the securities industry has vigorously championed the arbitration process, Rodriguez de Quijas v Shearson/American Express, Inc., 490 US --, 109 S.Ct. 1917, 104 L.Ed.2d 526 (1989). However, not all members of the industry agree that the process is fair and there is no incongruity in a challenge by one member of an industry, even if the industry as a whole strongly favors arbitration, Quick & Reilly, Inc. v Jacobson, 126 FRD 24, 27 (S.D.N.Y. 1989).

Our perception of arbitration in the two cases in which we have been directly involved has generally been favorable. However, there are a few comments we would like to make arising out of our arbitration experience. In the first case, we offered to settle with a customer by splitting the loss on an order which was not cancelled when a new order was placed. We contended that the customer should have cancelled the first order, while the customer claimed that we were responsible, even if the customer forgot. The loss was $2200 and we offered $1100 as a fair compromise. The customer refused to accept our offer and filed an arbitration claim for the full amount. Eighteen months later, an arbitrator awarded her $600 on the theory that she should bear the major responsibility for cancelling an order, and that she should have promptly informed the broker when she learned that the order had been executed twice, rather than waiting to speculate on which way the price of the stock would go.

The second case in which we were involved arose out of the extraordinary stock market events of October 19 and 20, 1987. (The findings and award of the arbitrators is attached hereto.) Basically, a client failed to meet a margin call and was sold out. However, due to the unusual failure of market mechanisms during those two days (see, Report of The Presidential Task Force on Market Mechanisms, Nicholas F. Brady, Chairman, January 8, 1988) there was an oversale of securities for his account. However, the value of the account declined even further for 10 weeks and the client bought back at a lower price one of the securities which had been sold. He also waited to speculate on which way the market was going, and did not make any claim until six months after the occurance of these events, all the time continuing to do business with us. During the course of the arbitration, the customer submitted backdated documents, entered perjured testimony and suborned the testimony of two other witnesses, one his sister and the other his employee. This became apparent to the arbitrators.

First, I must point out that, while there are certainly dishonest or wrongful acts by brokers, there are also dishonest acts by customers. An arbitration process which leans toward the customer to the extent that the customer has nothing to lose and everything to gain is less than a neutral forum. It encourages unscrupulous customers and their attorneys to file claims on the theory that such claims serve as leverage to negotiate a settlement which a court would not allow. Indeed, in the second case cited above, since the customer's securities declined below his sales prices, he could not show any damage and in a court of law a motion to dismiss would have been sustained for failure to state a cause of action. Thus, at the outset the case would not have crossed the threshold. Instead, we were forced into arbitration, since we allow the customer to select the forum (and we could not move the case into court before arbitration -- indeed, after selecting the arbitration forum, the customer's attorney accused us of forcing his client into arbitration!). We incurred substantial costs in both time and attorney fees. We were not awarded these costs by the arbitrators, but instead were assessed a forum fee. It seems to me that allowance should be made for the arbitrators to award costs to the prevailing party as a deterrence to claims without substantive foundation or filed with fraudulent intent.

Second, our limited exposure has shown that many arbitrators are inexperienced in the securities industry. Unfortunately, to obtain experienced arbitrators requires getting them from the industry, and many of these are unfamilar with legal principles. To that extent, there may be an unfairness to the customer, or at least a perceived unfairness. A possible solution might be a system similar to administrative law judges, that is, arbitrators who are attorneys but who specialize full-time in arbitrating securities cases. Such a system is not without its drawbacks, not the least of which is adequate funding, but at least it would be fair to all parties, rather than the current haphazard method of choosing arbitrators unfamilar either with the law or the securities industry.

Third, arbitrators may make mistakes and the present system provides little opportunity to rectify them. Appeals are available only upon the most limited grounds, [Federal Arbitration Act, 9 USC 10]. Yet, most human endeavors are not subject to such certainty or finality. Indeed, an arbitration award is tantamount to a financial death penalty, since there is essentially no recourse after the award or lack thereof. There should be a process for review upon application of either party, perhaps by another arbitration panel (composed of attorneys?), to determine at least the correctness of law, if not of fact.

Fourth, arbitrators should be required to summarize the claim, their findings and the reason for their award. The present system leaves both parties in the dark when arbitrators fail to provide even a barebones minimum rationale. Such a statement need not be long; surely the points and authorities cited by a court are unnecessary. But at least an explanation of how the determination was made would foster an increased appreciation of the fairness and integrity of the process. A system of conflict resolution must not only render justice, it must be perceived by the public to render justice so that confidence in the securities markets of the United States will not be undermined. In securities transactions controversies will inevitably arise. A fair, speedy, efficient method to resolve them is essential.

We applaud the Subcommittee's work and your efforts, Mr. Chairman, in reviewing the arbitration process in the securities industry. We thank you for this opportunity to be heard on the record. We hope our comments will prove useful.

Sincerely,

Leslie Harris

Leslie U. Harris
Managing Partner

LUH/hl

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHAIRMA

October 19, 1990

Mr. Michael Stein
Senate Committee on Banking,
  Housing and Urban Affairs
SD534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Stein:

Please find enclosed responses from Mr. Joseph Goldstein, Associate Director of the Commission's Division of Enforcement, to questions submitted to him by Committee staff in connection with his testimony of February 8, 1990. I regret our delay in furnishing these responses and appreciate your patience in waiting for them. As we discussed earlier today, the responses speak to matters as of the date of the testimony.

Sincerely yours,

Peter Kiernan

Peter Kiernan
Legislative Counsel

cc: Joseph Goldstein
    Sarah Ackerson

Question 1

How many people do you have working solely on penny stock fraud cases?

A: Given the breadth of the Commission's enforcement responsibilities, Commission enforcement staff typically are not assigned one area in which to specialize. Moreover, penny stock fraud is no longer unique to one area of the country. Accordingly, every Commission office is expending resources in investigating and prosecuting penny stock fraud cases. At any given time members of the Commission's staff may work solely on penny stock fraud cases; however, as a general matter, no member of the Commission's professional staff has been assigned responsibility to specialize in these cases.[1] In fiscal year 1989 the Commission expended approximately 90 staff years on penny stock fraud cases. Additionally, approximately 42 staff years were expended by Commission examination staff upon examinations of broker-dealers active in the penny stock market. Approximately 47% of these examinations resulted in referrals for enforcement action.

Question 2

How many penny stock cases has the Task Force and the SEC brought since its inception? How many cases is the Task Force currently working on?

A: In fiscal year 1989, the Commission brought 68 penny stock actions and issued 22 trading suspensions involving penny stocks. In addition, the Commission currently has more than 100 active open penny stock cases.

Question 3

Where are the Task Force's strengths in its efforts of combatting penny stock fraud? What do you see as the Task Force's deficiencies? How can the SEC improve upon these deficiencies?

A: The strengths of the Task Force are best measured by its ability to achieve its goals--(1) increased enforcement actions against penny stock violators and criminal referrals where appropriate; (2) increased investor awareness about penny stock fraud and how to avoid it; (3) targeted regulatory solutions; (4) increased coordination and information-sharing with other federal, foreign, state and local regulators and prosecutors who also have responsibility for preventing penny stock fraud. The Task Force has made significant progress toward achieving each of these goals. Details are contained in the Commission's written testimony. In summary, however, the Task Force's efforts include:

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1. Two staff members are assigned the primary responsibility to manage and administer matters relating to the Penny Stock Task Force.

- Holding numerous, well-attended conferences with high level representatives of other concerned federal, local, state, and foreign law enforcement agencies;
- Establishment of the Florida Penny Stock Task Force, which consists of representatives of the Commission, the State of Florida, the National Association of Securities Dealers ("NASD"), U.S. Attorneys' Offices, the FBI, the IRS and other federal law enforcement agencies;
- Providing training for federal, local, state, and foreign law enforcement personnel, with a view to maximizing their capabilities successfully to bring penny stock cases;
- Increased sharing of investigative information from Commission files with other investigative and prosecutorial agencies;
- A 58% increase in the number of penny stock enforcement actions;
- Escalating the number of inspections that target penny stock broker-dealers;
- Active provision of assistance to criminal prosecutors in the prosecution of penny stock fraud in order to maximize the deterrent effect of enforcement actions in the penny stock area;
- Commission adoption of Rule 15c2-6 under the Securities Exchange Act of 1934 ("Exchange Act"), a major regulatory initiative directly aimed at preventing fraudulent penny stock sales tactics;
- Commission proposal of amendments to Rule 15c2-11 under the Exchange Act that would help to assure that market makers in penny stocks have an adequate basis for their quotations regarding penny stocks and minimize the possibility that legitimate market makers might unknowingly facilitate schemes to manipulate the price of penny stocks;
- Encouraging initiatives of other regulatory organizations, such as the NASD's adoption of new Schedule H of its by-laws, which increases substantially the information regarding the non-NASDAQ over-the-counter market, and the NASD's Electronic Bulletin Board which provides an automated quotation medium for non-NASDAQ, OTC securities;
- Increasing investor awareness of how to recognize and avoid fraudulent penny stock schemes by preparing and distributing public educational bulletins and encouraging media coverage of the efforts and focus of the Penny Stock Task Force.

The Commission and the Task Force are committed to the continuation of these efforts. In addition, by adopting needed legislation, the Congress can assure that the Task Force's success will continue and that its ability to achieve its goals will be enhanced.

In 1989, the Commission sent to Congress two legislative initiatives, the provisions of which, although not specifically targeted toward the penny stock fraud problem, would provide the Commission with greater enforcement capability for use in attacking penny stock fraud. These proposals have been introduced as H.R. 975 and S. 647, the Securities Law Enforcement Remedies Act of 1989 and H.R. 1396 and S. 646, the International Securities Enforcement Cooperation Act of 1989. The Senate bills were jointly introduced by Chairman Dodd and Senator Heinz. The Senate has passed H.R. 1396; it is currently pending before the House.

Affirmative action by the Congress on both bills would enhance the Commission's enforcement ability in several important respects. The Securities Law Enforcement Remedies Act would alter the economic consequences of securities law violations, and would thereby deter violations for financial gain and violations by recidivists who have not been deterred by prior sanctions imposed upon them. Money penalties would give the courts and the Commission greater flexibility to tailor a remedy to the gravity of the violation. In addition, the Commission recently proposed revisions to the bill. The revisions would add cease-and-desist authority to the Commission's enforcement powers. The authority would make the Commission's enforcement process more efficient, flexible, precise, and fair, and enable the Commission to provide needed protection to the investing public with increased speed. Express judicial authority to impose corporate bars and suspensions in cases of violations of Section 17(a)(1) of the Securities Act or Section 10(b) of the Exchange Act, which also have been proposed as part of the legislation,[2] would resolve any doubts about the propriety of this of this remedy. Finally, the act would amend the federal Criminal Code to authorize a court to issue an order permitting disclosure to the Commission of grand jury information concerning potential securities law violations for use in matters within the Commission's jurisdiction.

The International Securities Enforcement Cooperation Act would permit greater flexibility in responding to problems incidental to the increasing internationalization of the securities markets. Among other things, the Act would permit the Commission and the SROs to deny registration to persons who have been sanctioned by foreign regulators, thereby preventing those individuals from "setting up shop" in the United States after their fraudulent conduct has been uncovered elsewhere. Enactment of this bill would also further international enforcement cooperation, which has proven essential to the attainment of the Penny Stock Task Force's goals. In particular, the bill would exempt confidential documents received from foreign authorities from disclosure requirements under the Freedom of Information Act ("FOIA"). Conflicts between the confidentiality requirements of foreign nondisclosure laws and the FOIA have been an impediment to the receipt of information from, and negotiation of memoranda of understanding with, foreign authorities. In addition, the Act would make explicit the Commission's authority to enact rules allowing it to provide nonpublic documents and other information to domestic and foreign authorities.

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[2] Commissioner Fleischman has concurred in this proposal but has not concurred in the other legislative recommendations referred to in this paragraph.

Question 4

> *Does the SEC (or NASD) as a matter of course make an immediate referral to appropriate criminal authorities when it begins an investigation of penny stock fraud which also appears to involve criminal conduct? If not, why not? What is the SEC's (or SRO's) policy with respect to criminal referrals? If so, what is the typical reaction of the criminal enforcement authorities? Do the civil and criminal authorities then work together to bring a case?*

A: The Commission has long recognized that criminal prosecution of those who engage in serious violations of the federal securities laws is an essential component of an effective enforcement program. In order to ensure that appropriate criminal prosecutions occur, the Commission has actively sought to foster productive working relationships with federal, state, local and foreign criminal prosecutorial authorities, to provide their personnel with necessary training, to apprise them of cases in which they may have an interest and, in general, to provide the fullest cooperation possible. We understand that the SRO's are also fully committed to assisting criminal law enforcement authorities.

An example of the Commission's efforts and those of the principal SRO's in this area is membership and active participation in the Securities and Commodities Fraud Working Group, a group sponsored by the Department of Justice. The purpose of the group is to facilitate communication and cooperation among securities and commodities regulators and prosecutors and thereby to enhance the success of our respective efforts to ensure honest markets and trading activities.

Reflecting the Commission's policy and experience with respect to criminal prosecution, the goals of the Penny Stock Task Force include increasing criminal referrals where appropriate and increasing coordination and information-sharing with other federal, foreign, state and local prosecutors who have responsibility for preventing penny stock fraud. Efforts of the Task Force to achieve these goals include: holding conferences with prosecutors; establishment of the Florida Penny Stock Task Force; providing training to law enforcement personnel, including programs for FBI agents and two national training programs on penny stock manipulations held under the sponsorship of the Securities and Commodities Fraud Working Group; increased sharing of investigative information; and active provision of assistance in criminal penny stock fraud prosecutions.

As a result of the Commission's overall policy and the efforts of the Penny Stock Task Force in furtherance of its goals, criminal law enforcement authorities are typically apprised at an early stage of penny stock fraud investigations in which they may have an interest. Usually, criminal prosecutors will request and receive access to the Commission's nonpublic investigative files after the Commission has developed sufficient evidence of violative conduct, at a time when the matter is ripe for consideration by criminal prosecutors. The Commission generally provides other assistance as may be required for effective presentation or prosecution of the case.[3]

During fiscal year 1989, the total number of access grants to criminal law enforcement authorities increased by 66% over the prior fiscal year. While the dramatic increase is not fully and directly attributable to the Commission's activities aimed at penny stock fraud, it is indicative of the Commission's overall efforts to improve coordination and cooperation with law enforcement agencies.

When apprised of penny stock fraud violations, criminal law enforcement agencies have generally been responsive to the need for coordinated action, and have been willing to work closely with the Commission to bring successful prosecutions. In appropriate cases, the Commission and criminal law enforcement agencies have brought complementary administrative, civil and criminal actions. For example, in the recent Protecto Industries, Inc., undercover operation, the Commission's Salt Lake City and Denver offices provided technical assistance to the FBI during the operation. The U.S. Attorney in Salt Lake City subsequently brought criminal actions against ten defendants, some of whom were also named as defendants in a civil action brought by the Commission. The Commission also instituted administrative proceedings pursuant to Rule 2(e) of the Commission's Rules of Practice against an accountant who had been charged criminally.

Question 5

What kind of sanction is typically imposed on the brokers who participate in a boiler room shop stock manipulation scheme?

A: The Commission may bring administrative proceedings or civil injunctive actions to remedy violations of the federal securities laws. In its administrative proceedings, the Commission has authority to censure a securities firm, suspend or revoke its registration, or place limitations on its activities. The Commission may also censure individual respondents, suspend or bar them from association with securities firms, or place limitations on their activities. Professionals such as accountants and attorneys who engage in improper conduct may be suspended or barred from practicing or appearing before the Commission.[4] Typical relief obtained in Commission penny stock administrative proceedings include the imposition of bars and revocations (or permitting withdrawals) of a securities firm's registration with the Commission. Additional relief commonly obtained in these cases is a stop order——an order that either refuses to permit a registration statement for the sale of securities to become effective or suspends the effectiveness of such a registration statement.[5]

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[3] The Commission is authorized by the federal securities laws to refer matters to the Department of Justice for possible criminal action. *See* Section 20(b) of the Securities Act of 1933; Section 21(d) of the Securities Exchange Act of 1934. However, formal criminal referrals under these provisions are to be distinguished from the routine access procedures, which are relied upon in most cases and provide criminal prosecutors needed information and support on an expedited basis.

The Commission has statutory authority to seek civil injunctions against future violations of those provisions of the federal securities laws that were violated. By virtue of the inherent equitable authority of the federal courts, additional relief may be awarded, including orders requiring asset freezes, the submission of accountings, and the disgorgement of illicit profits. Additionally, failure to comply with an injunction may result in an order of civil or criminal contempt.

Regardless of the nature of the violations that may have occurred, relief sought by the Commission in its cases is necessarily made on a case-by-case basis in light of all relevant considerations, including such factors as the defendant/ respondent's: relative culpability; degree of *scienter;* length of time in the securities business; likelihood of engaging in future violations of the federal securities laws; and susceptibility to remedial relief, such as an order appointing a committee of experts to examine the circumstances of violations and to make a report and recommendations on procedures to prevent recurrences. As indicated above,[6] the Commission's ability to fashion appropriate sanctions in its cases would be significantly enhanced by enactment of The Securities Law Enforcement Remedies Act, principally through the addition of money penalties and cease and desist authority to the Commission's enforcement authority.

The Commission's penny stock enforcement proceedings instituted in fiscal year 1989 involved 58 respondents in administrative proceedings, 113 defendants in injunctive proceedings, and 2 respondents to motions for orders to show cause why the respondents should not be held in contempt of previously-issued civil injunctions. The chart below shows the relief ordered in these cases.

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[4] These bars are issued in administrative proceedings brought pursuant to Rule 2(e) of the Commission's Rules of Practice [17 CFR 201.2(e)].

[5] *See* Securities Act of 1933 §§ 8(b) and (e).

[6] *See* the response to Question 3 *supra* at 3-4.

Action Type	Nature of Relief	Number of Defendants or Respondents
Administrative Proceedings[7]	Bar[8]	32
	Revocation or Withdrawal of Registration	6
	Stop Order	4
	Suspension	1
	Censure	5
	Pending	13
Civil Injunctive Actions	Permanent Injunction	62
	Pending	51
Contempt Proceedings	Contempt Order	1
	Pending	1

In those civil injunctive actions in which the Commission obtained orders of permanent injunction, courts commonly entered orders providing for additional equitable relief, such as orders requiring disgorgement of illicit profits.

Question 6

> *When the Commission (or NASD) suspends an individual from the securities business, whether temporarily or permanently, how is the regulator able to ascertain whether the sanction has been complied with?*

A: Both the Commission and the NASD review for compliance with suspensions through their broker-dealer examination programs. Under these programs, Commission and NASD examiners routinely conduct on-site examinations of member broker-dealers to assure that they are in compliance with federal securities laws. As part of their examinations, the Commission and NASD staff compare the personnel list of a firm with the firm's payroll to determine who the firm actually employs.

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[7] A number of administrative proceedings in which relief was obtained involved the imposition of more than one type of sanction.

[8] A bar may completely prohibit association or prohibit association in a specified capacity, such as a supervisory or proprietary capacity. Additionally, Commission bar orders often contain provisions that permit an application for reentry to the securities business after expiration of a specified period of time.

The NASD's registration process for individuals who buy and sell securities professionally also provides a way for the NASD to ensure that persons subject to a bar comply. When an individual wants to re-enter the securities business, the broker-dealer employer must register any associated person on a standardized industry form, Form U-4, which reflects all disciplinary history and employment for 10 years. This information is subject to review by the NASD and subsequently is retained in the Central Registration Depository ("CRD"). CRD is a computerized filing and data processing system that includes all registered broker-dealers and their associated persons. It is jointly owned by the NASD and the North American Securities Administrators Association. Among the information in CRD are the enforcement actions taken by the Commission, the SROs, the Commodity Futures Trading Commission and the state authorities with respect to registered broker-dealers and their associated persons. Consequently, this screening process should prevent suspended individuals from becoming or remaining associated with a securities firm.

The Commission is aware of instances in which persons who were barred from associating with a broker-dealer or, by order, otherwise sanctioned by the Commission to re-enter the securities business as unregistered "consultants" or "promoters". By labeling themselves in this manner, barred persons have contended that they are not covered by the current statutory definition of "associated person" and are therefore not required to register through CRD. For this reason, the Task Force has asked the Division of Market Regulation to draft new regulations which would more effectively exclude all persons who are barred from the securities industry. One such measure under consideration is a new rule under the Exchange Act that would provide greater clarity as to the functions that constitute an "association" with a broker-dealer.

Question 7

Does the NASD advise its member broker-dealers of all persons suspended or barred from the industry by itself, the SEC or state regulators?

A: Yes. As described above, enforcement actions taken by the NASD, the Commission, the other SROs and the state authorities are reflected in the CRD, to which all registered broker-dealers have access.

Question 8

What sanctions are available (and imposed) against broker-dealers which employ suspended or barred persons? Is the firm's registration revoked?

A: Section 15(b)(6) of the Exchange Act prohibits a broker-dealer from permitting a barred person to become associated with the broker-dealer without the consent of the Commission if the broker-dealer knew, or in the exercise of reasonable care, should have known of the existence of the bar order. Pursuant to Section 15(b)(4) of the Exchange Act, the Commission may "censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration" of any broker-dealer upon a finding that such sanction is in the public interest and that the broker-dealer willfully violated any provision of the Exchange Act.

Commission cases against broker-dealers for unlawfully employing a barred or suspended person are comparatively uncommon. As with all its cases, however, the nature of the sanction to be imposed is dependent upon the facts and circumstances of the case.[9] As an example, one recent case in which the Commission alleged that a broker-dealer had unlawfully employed a barred person was concluded by the Commission ordering the broker-dealer to comply with undertakings: (i) not to attempt to withdraw the broker-dealer's application for withdrawal of registration; and (ii) not to attempt to register with the Commission or to operate as a broker-dealer in the future.[10]

Question 9

In your view, are the Justice Department and the state law enforcement authorities devoting sufficient resources to this problem? What more should they be doing?

A: The Commission has been pleased with the assistance it has received from the Department of Justice and state law enforcement authorities. The efforts of the Penny Stock Task Force to foster cooperation and information sharing have resulted in more active criminal investigations of penny stock violations, and the filing of an increased number of criminal cases. Criminal law enforcement agencies have also demonstrated their commitment in other ways to the prevention of penny stock fraud. For example, the Justice Department's Securities and Commodities Fraud Working Group has sponsored two-day training programs, hosted by the Commission, to familiarize federal, state, foreign and local prosecutors and regulators with issues relating to securities and commodities fraud. Federal and local law enforcement agencies have also participated in regional groups, such as the Florida Penny Stock Task Force, to facilitate the exchange of information, and more efficiently to mobilize and coordinate the resources of the participants. More generally, the Department of Justice has announced an increased dedication of resources to the investigation and prosecution of white collar crime.

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[9] For a listing of factors commonly considered by the Commission in determining relief appropriate to a case, *see* p. 6, *supra*.

[10] *In the Matter of Robert M. Winston*, Securities Exchange Act Rel. No. 27329, Admin. Proc. File No. 3-6986 (Oct. 25, 1989).

The Commission believes that law enforcement agencies have recognized penny stock fraud as an important enforcement priority, and have committed resources accordingly. However, the Commission is aware that these agencies have other competing priorities. Because our primary focus is upon enforcement of the federal securities laws, we are not in a position to assess the overall law enforcement strategies of these agencies.

Question 10

> *Some commentators have expressed concerns about the proliferation of investment newsletters——publications which purport to provide professional investment advice and which are typically directed at smaller investors. Critics of these publications note that some persons write literally dozens of newsletters under different titles offering, sometimes providing, conflicting investment advice. Concerns have also been raised regarding the incidence of "touting"--extolling the virtues of a particular penny stock company after having received payment from the company or taking an ownership position in the stock. What securities laws and regulations are investment newsletter publishers and writers subject to? Must they have a reasonable basis, supported by fact, for making their "recommendations"?*

A: Section 202(a)(11)(D) of the Investment Advisers Act of 1940 ("Advisers Act") excepts from the definition of investment adviser the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation. In this regard, the Supreme Court recently held in *Lowe v. S.E.C.*, 472 U.S. 181 (1985) that publications that offer only impersonal investment advice in a bona fide publication of general and regular circulation are not subject to the Advisers Act. The Court stated in that case that "presumably, a 'bona fide' publication would be genuine in the sense that it would contain disinterested commentary and analysis as opposed to promotional material disseminated by a 'tout.'" The Commission's staff, as a general matter, does not opine on the availability of the publisher's exclusion or the applicability of the *Lowe* decision to a particular publication.

Regardless of whether they are required to register under the Advisers Act, newsletter publishers who engage in fraudulent activities are also subject to the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. These provisions would apply, for example, to a newsletter publisher who intentionally disseminated materially false or misleading information for the purpose of manipulating the market for a particular security. With respect to touting, Section 17(b) of the Securities Act specifically prohibits the publication of information about a security in return for consideration from an issuer, underwriter, or dealer, without fully disclosing the receipt of such consideration.

Question 11

> *The argument has been made that the 1st Amendment protects the right of newsletter writers to say just about anything. Why would this be any more true for investment newsletter writers than for contested proxy solicitations, where proxy material is subjected to prior review by the Commission's staff? It is my understanding that in proxy contests, the staff requires that solicitation statements be supported by documentation provided to the staff.*

A: The argument "that the 1st Amendment protects the right of newsletter writers to say just about anything" in the context of the laws, rules and regulations administered by the Commission has not been conceded nor is there any final judicial determination to this effect of which we are aware.

With respect to contested proxy solicitations, soliciting material used is generally subject to a prior staff review. However, speeches, press releases and television or radio scripts are not subject to prior staff review. A major purpose of this review is to determine whether or not the material contains any statements prohibited by Commission Rule 14a-9. That rule forbids the inclusion of false or misleading statements about material facts and material omissions of act in any proxy-soliciting material. This prohibition is applicable to every soliciting person——Board of Directors and opposition parties alike. Frequently, to aid in its review, the staff requests that statements in these materials which purport to be matters of fact be supported by supplemental information which shows the factual nature of such statements. This procedure helps the soliciting person to distinguish and clearly identify and label matters of opinion, in contrast to matters of fact in the proxy-soliciting materials; thus, it is believed that many false and misleading statements of supposed fact are avoided.

Question 12

Last year, Business Week did a story on penny stock fraud and discussed the activities of a newsletter publisher by the name of Joel Nadel. The article indicated that the Commission was investigating whether Nadel had played an active role in stock manipulation schemes. Has the Commission ever sanctioned Nadel or other newsletter writers?

A: The Commission previously had instituted administrative proceedings against Joel S. Nadel in 1970--an action unrelated to Mr. Nadel's newsletter activities.[11] In an order imposing sanctions upon Nadel, the Commission found that he had violated the registration provisions of the Securities Act by selling the unregistered securities of three issuers, and that he had violated the antifraud provisions of the Securities Act and the Exchange Act by, among other things, making false and misleading statements concerning the plan of distribution of one of the stocks, the source of that stock, the commissions, markups, profits and other compensation received by him, the completion of the offering, and the identities and ownership interests of the issuer's promoters.[12] Nadel, without admitting or denying the Commission's allegations, consented to the entry of the order, by which he was barred from association with any broker, dealer, registered investment adviser, or registered investment company, with the provision that he could apply to become so associated after a period of two years on a showing that for two additional years he would function only in non-supervisory capacities and would be adequately supervised.

The Commission has taken action in cases involving fraud and other violative conduct by writers and publishers of newsletters. In the penny stock area, for example, the Commission's action against two former shell companies, Dynapac, Inc., and Sedona Corporation, included the charge that Elliot R. Pearson, the publisher of "The Silver Baron," an investment advisory newsletter, fraudulently promoted Dynapac in the newsletter, engaged in undisclosed trading in the company's stock and received undisclosed compensation in the form of Dynapac stock for touting the company.[13]

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[11] *In the Matter of Nadel & Co.*, Securities Exchange Act Release No. 8962 (Aug. 20, 1970). Prior to the institution of administrative proceedings, Nadel, without admitting or denying the Commission's allegations, consented to the entry of an injunction, in a related civil action, against violations of the registration provisions of the Securities Act. *SEC v. Creative Financing, Inc.*, Civil Action No. 21392 (D.Md.), Litigation Release Nos. 4464 (Nov. 6, 1969) and 4569 (Mar. 26, 1970).

[12] *In the Matter of Joel S. Nadel*, Securities Exchange Act Release No. 9067 (Jan. 27, 1971).

The Commission has brought a range of other cases, some of which also involved failure to disclose compensation received in exchange for touting an issuer's stock,[14] or involved false and misleading claims about the success of a publication's recommendations.[15] Other Commission cases have involved the use of newsletters to communicate false and misleading information with respect to particular securities, either by investment advisers,[16] or by brokers.[17]

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[13] *SEC v. Dynapac, Inc.*, Civ. No. 87-Z-1130 (D.Colo.) Litigation Release Nos. 11262 (Oct. 15, 1986); 11799 (Jul. 13, 1988)(settlement of Blaine C. Taylor); and 11930 (Dec. 7, 1988) (settlement of Pearson and "The Silver Baron"); *see also, SEC v. Laurins*, Civil Action No. C-88-1899 (N.D.Cal.), Litigation Release Nos. 11758 (Jun. 2, 1988) and 12229 (Aug. 24, 1989) (publisher of newsletter directed at the shareholders of Chopp Computer Corporation, Inc. attacked company's credibility and advised readers to sell Chopp common stock short, without disclosing publisher's own substantial short position in the stock).

[14] *See, e.g., SEC v. Financial Observer/West*, Civil Action No. CV-88-5819-SVW-Ex (C.D.Cal.), Litigation Release No. 11879 (Sept. 29, 1988); *In the Matter of Edwin Fishbaine /b/a The Terex Report*, Investment Advisers Act Release No. 1134 (Aug. 2, 1988); *In the atter of Penny Stock Newsletter, Inc.*, Investment Advisers Act Release No. 946 (Dec. 19, 984).

[15] *See, e.g., In the Matter of The Blue Chip Market Advisor, Inc.*, Investment Advisers Act Release No. 1207 (Oct. 25, 1989); *SEC v. F.X.C. Investment Group, Inc.*, 85 Civ. 3306 (S.D.N.Y.), Litigation Release No. 10757 (May 9, 1985); *In the Matter of John Martone d/b/a The John Martone Letter*, Investment Advisers Act Release No. 1089 (Sept. 30, 1987); *In the Matter of John Wesley English*, Investment Advisers Act Release Nos. 1005 (Jan 8, 1986) and 1006 (Jan 8, 1986); *SEC v. Financial News Associates*, Civil Action No. 84-0878-A (E.D.Va.), Litigation Release No. 10736 (May 2, 1985).

[16] *See, e.g., SEC v. Pavarini*, 88 Civ. 4897 (S.D.N.Y.), Litigation Release 11801 (Jul. 14, 1988).

[17] *See, e.g., SEC v. Hughes Capital Corporation*, Civil Action No. 88-5238 (D.N.J.), Litigation Release No. 11939 (Dec. 13, 1988); *In the Matter of Martin Rothman*, Securities Exchange Act Release No. 23654 (Sept. 30, 1986).

Question 13

According to the September 1989 report by the state securities administrators (NASAA) on the penny stock market, total annual primary and secondary market activity is estimated to be $10 billion, with American investors losing at least $2 billion each year as a result of fraudulent offerings and schemes. In your view, is there actually a legitimate penny stock market? Do clean and legitimate penny stock broker-dealers exist? Is there a real demand for penny stocks? Outside of the small investors that are obviously being ripped off, what kind of interest is there for this type of security? If the California prohibition of initial public offerings with less than a two dollar selling price were implemented nationwide, who would be harmed? What do you see as the redeeming and beneficial aspects of the penny stock market?

A: There is a legitimate market for penny stocks, and reputable broker-dealers participate in this market. Many small businesses rely on the market for low-priced securities as a source for capital that cannot be obtained satisfactorily through venture capital or private placements. For example, small issuers commenting on the Commission's new penny stock rule, Rule 15c2-6 under the Exchange Act, indicated that this market provided a critical source of capital in the early stages of their development. In addition, the Commission staff directly contacted several small, reputable broker-dealers to discuss their activities in small business securities and the effect of the proposed penny stock rule. These broker-dealers indicated that they typically sell securities issued by smaller issuers to long-term investors who have the ability to evaluate the securities independently of the broker-dealer's recommendation. These investors often are associated in some way with the issuer, such as a supplier or consumer of the issuer's products. In addition, these broker-dealers indicated that they do not sell these stocks through "cold calls."

The primary value of the penny stock market therefore is that it provides an alternative source of capital for small companies, some of whom would otherwise be unable to obtain the capital they need. It is difficult to determine the specific proportion of broker-dealers who facilitate this legitimate function. One relevant indicator is the results of the Commission's examination program for penny stock broker-dealers. In the last 19 months, the Commission's regional offices have completed 197 examinations of penny stock broker-dealers. Referrals for enforcement consideration resulted out of 57.9% of these examinations, an indication that the examinations uncovered serious problems.

We believe that the Commission's penny stock program is reducing fraudulent penny stock activity and thereby is increasing the proportion of legitimate broker-dealers. Moreover, Rule 15c2-6 targets the boiler-room sales tactics of fraudulent penny stock broker-dealers and therefore should reduce substantially the ability of fraudulent firms to attract new business by selling penny stocks to unsophisticated investors.

The concept of a nationwide prohibition on initial public offerings at less than $2 per share raises important issues. The federal securities laws generally are based on a philosophy of disclosure, unlike the laws of many states that authorize state administrators to evaluate the merits of a particular offering. This philosophy of disclosure generally has worked well on the federal level, and we believe that federal resources are best directed towards preventing practices that seem to be used repeatedly to defraud investors. As discussed in the Commission's release adopting Rule 15c2-6, securities with low prices are more subject to manipulation and sales practice abuse than higher priced securities. The percentage spreads between bid and asked prices tend to be much larger in low-priced securities and therefore can generate huge profits for fraudulent broker-dealers. In addition, high pressure salespersons can sell low-priced securities to inexperienced investors by touting that a small gain in price will produce large percentage profits for the investor.

As discussed above, many established, small companies have issued shares priced at less than $2 per share. More than 40% of NASDAQ issues that are not designated as National Market System securities trade at less than $1 per share, many of which were initially sold to the public at prices in this range. It is not clear, however, that such a low share price is critical to a successful offering or an efficient secondary market in the securities of small businesses. Also, a share price criterion has been adopted in several other contexts involving securities regulation, such as Rule 15c2-6 and SRO listing requirements. Establishing an across-the-board "floor" for initial public offering prices would be a major step, however, and its effects would need to be evaluated thoroughly.

Question 14

> *Since S. 647 would only permit a court to bar securities law violators from serving as officers and directors of public companies, how will the SEC and state regulators confront the problem of illicit re-entry into the securities business by those who have put themselves out as "consultants"?*

A: Section 15(b)(6) of the Exchange Act provides authority for the Commission to bar persons from being associated with a broker-dealer. This section also makes it unlawful for a broker-dealer to permit such a person to become associated with the broker-dealer if the broker-dealer knew, or in the exercise of reasonable care should have known, that the person was barred. Section 3(a)(18) of the Exchange Act defines "person associated with a broker or dealer" in part as an employee of a broker-dealer or any person directly or indirectly controlling, controlled by, or under common control with, a broker-dealer.

The Commission is aware of instances in which persons who were barred from associating with a broker-dealer have re-entered the securities business as "consultants," "finders," or "promoters." By labeling themselves in this manner, barred persons have contended that they are not covered by the definition of "associated person." In a substantial proportion of such instances, the barred persons may in fact fall within the definition of "associated person" of a broker-dealer and thus are barred from engaging in the securities activities. Nonetheless, the Commission is considering new measures to more effectively exclude persons who have committed securities law violations from participating in the sale of securities to investors in any capacity, unless the person's activities have been approved by the Commission or an SRO as consistent with investor protection and are subject to clearly defined supervisory controls. One such measure under consideration is a new Exchange Act rule that would provide greater clarity as to the functions that constitute an "association" with a broker-dealer. The rule specifically would address "consultants."

Question 15

Does the SEC have the authority to bar persons from serving as consultants or advisors to broker-dealers? Does the NASD? If not, does the SEC or NASD have the authority to sanction a broker-dealer firm which uses the services of a person that has been suspended or barred?

A: Section 15(b)(6) of the Exchange Act provides authority for the Commission to bar persons from being associated with a broker-dealer. This section also makes it unlawful for a broker-dealer to permit such a person to become associated with the broker-dealer if the broker-dealer knew, or in the exercise of reasonable care should have known, that the person was barred. Section 3(a)(18) of the Exchange Act defines "person associated with a broker or dealer" in part as an employee of a broker-dealer or any person directly or indirectly controlling, controlled by, or under common control with, a broker-dealer. The NASD's authority under Section 15A of the Exchange Act also generally is limited to associated persons.

The Commission is aware of instances in which persons who were barred from associating with a broker-dealer have re-entered the securities business as "consultants," "finders," or "promoters." By labeling themselves in this manner, barred persons have contended that they are not covered by the definition of associated person. In a substantial proportion of such instances, the barred persons may in fact fall within the definition of "associated person" of a broker-dealer and thus would be barred from engaging in the securities business. Nonetheless, the Commission is considering new measures to more effectively exclude persons who have committed securities law violations from participating in the sale of securities to investors in any capacity, unless that person's activities have been approved by the Commission or an SRO as consistent with investor protection and are subject to clearly defined supervisory controls. As discussed earlier, one such measure under consideration is a new Exchange Act rule that would provide greater clarity as to the functions that constitute an "association" with a broker-dealer. The rule specifically would address so called "consultants" who have previously been barred.

Question 16

> *In their testimony today, both the SEC and the state regulators have urged the passage of S.647, the Securities Law Enforcement Remedies Act of 1989.*
>
> *One provision in the bill gives the SEC*[18] *and the courts the ability to bar law violators from serving as officers and directors of publicly held companies, which many think would be an important step in preventing recidivists from continuing to defraud investors.*
>
> *Does the SEC maintain statistical data on the number of enforcement actions brought against individuals who have been previously sanctioned for securities law violations?*

A: The Commission does not maintain separate statistical data on the number of enforcement actions brought against individuals who have previously been sanctioned for securities law violations. Based on a review of Commission data on its administrative and court actions, however, it appears that the Commission has brought at least 55 cases since 1980 against individuals who had been the subject of previous Commission enforcement actions. In addition, the Commission has brought over 50 civil or criminal contempt actions since 1986 against persons who have violated the terms of judicial decrees.

These data do not reflect the extent of the recidivist problem. They do not include enforcement actions brought against individuals whose prior violations were the subject of proceedings brought by criminal authorities, self-regulatory organizations or state securities commissions. They also do not include cases brought against individuals whose prior violations were the subject of private actions.

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18. S.647 contains provisions that would amend Section 15(c)(4) of the Exchange Act. Among other things, the amendments would authorize the Commission to bar persons from serving as officers and directors of reporting companies. The Commission recently submitted a revised legislative proposal to Congress. In light of the recommendation in the revised proposal that Congress provide the more comprehensive and flexible cease-and-desist remedy, the Commission no longer believes that it is necessary to provide the authority for the Commission to impose corporate bars in its administrative proceedings. As in S.647, however, the revised legislative proposal recommends that the federal courts be authorized to impose corporate bars in civil actions filed by the Commission for violations of Section 17(a)(1) and 10(b) and rules thereunder.

Question 17

What kind of impact do you foresee S.647 having on the problem of recidivism, especially in the area of penny stock market fraud where repeat offenders seem continually to set up shop and perpetuate fraudulent scams?

A: Increasingly, the Commission has been confronted with persons who are willing to violate the securities laws despite the prior imposition of other civil or administrative sanctions against them for the same or similar conduct. If a respondent engages in conduct that violates a Commission administrative order, the Commission's only current remedy is to seek a mandatory injunction directing compliance with its order. Moreover, although a defendant who violates a court injunction may be prosecuted in a criminal contempt action, the criminal standard of proof is difficult to meet, and the contempt remedy does not address unlawful conduct that is outside the scope of the injunction.

A primary purpose of S.647 is to deter violators, particularly recidivists, by authorizing the Commission to impose substantial money penalties in administrative proceedings and to seek such penalties in civil actions. The addition of civil penalties to the enforcement arsenal would increase the costs associated with securities law violations, and, by altering the economic consequences of violations, would deter wrongful conduct engaged in for financial gain. Both the Commission and the courts could take prior violations into account when imposing civil money penalties, thereby achieving greater deterrence against violators who are not deterred by the civil and administrative remedies currently available.

Question 18

Do you feel that the monetary penalties that may be assessed by the courts under S.647 will serve as a sufficient deterrent to penny stock fraud perpetrators?

A: The Commission believes that the civil penalties provided by S.647 would have a significant deterrent effect, particularly upon penny stock fraud and other illegal conduct that may now appear lucrative to violators. The penalty provisions of the proposed legislation would set the maximum amounts for penalties assessed by the Commission in administrative proceedings at $100,000 per violation committed by a natural person, and $500,000 per violation committed by any other person. In cases in which the violative conduct results in illegal gains substantially in excess of these maximum amounts the Commission expects that it would bring civil actions in federal court. The proposed legislation provides that the maximum civil penalty that a court could impose would be the greater of the specified amounts or the gross amount of pecuniary gain to the defendant as a result of the violation.

Question 19

In the September 1989 NASAA Report on Fraud and Abuse in the Penny Stock Market, NASAA concludes "no clear economic justification exists" for "blank checks" blind pools.

What are the differences between a "blank check blind pool" and a venture capital fund that raises money from a group of investors who seek return on their investment in small businesses or start-up companies?

What about the established investment banking houses, such as Kohlberg, Kravis, Roberts or Forstmann, Little, that set up LBO funds in order to raise capital to make future acquisitions. How does this differ from a blank check, blind pool?

Institutional investors, such as pension funds, insurance companies and corporations are apparently investors in these established capital raising funds, playing a major role in providing growth and investment capital. If blank check blind pools were barred, what would the impact be upon the venture or start-up capital market?

A: "Blank check" offerings involve companies, typically with few or no assets, no current operations, and no stated business purpose except to merge with a presently unknown private company.[19] Managers of these companies frequently have little or no business experience, even in the business of locating merger prospects. Their securities are sold on the basis of only the most general information about their business plan. Investors are asked to part with their money without even knowing who the actual managers of the business ultimately acquired will be. Their return on investment is a matter of sheer speculation, based as it is on the performance of some unknown, undefined business. Although private companies may be enticed into merging with these companies through the allure of captive public investors, an ostensible source of additional funds, such promise may be more illusory than real. Because of the typically thin capitalization which these companies start with, any benefits the private company may derive from merging with the "public" company appear to marginal; it is questionable that such a merger constitutes an efficient source of funding for the private company.

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[19] These companies should not be confused with those which intend to operate in a specific identified business and offer their securities on a "blind pool" basis. This financing approach has been used for years in the real estate, oil and gas exploration, equipment leasing and other industries. Proceeds from a securities offering made on a "blind pool" basis are to be invested in properties or businesses of specified types, although at the beginning of the offering, the specific acquisitions to be made are unknown.

In significant contrast to these entities is the business described in the inquiry as a "venture capital fund that raises money from a group of investors who seek return on their investment." These entities typically are quite substantial--paid-in capital of the 100 largest venture capital firms in 1988 ran from a high of $1.3 billion to a low of $7 million, according to *Venture* magazine. These entities are in the business of being professional investors. They are a viable source of management expertise and money. Whether they target start-up, early-stage, later financing, or leveraged buyout transactions for investments, they are working for a return on their investment within certain predetermined limits, whether it be based on some length of time, type of transaction, or other measure. Investors in these entities are putting their money behind and into the experience, effectiveness and integrity of the professional investor, whose identity and track record is well known--an essential characteristic in order to draw the large amounts of money needed to effectively operate this type of business. The opportunity to invest in these entities is usually unavailable to the small and unsophisticated investor. For this reason, the offerings typically are not filed with the Commission and subject only to the broad anti-fraud proscriptions of the federal securities laws.

"Blank check" offerings and venture capital funds seem to be mutually exclusive so that a ban of "blank checks" offerings should have no impact on the other capital raising vehicle.

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